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VOL 3254

No. 17,348

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**COURT OF APPEALS**  
**for the Ninth Circuit**

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UNITED STATES OF AMERICA,

*Appellant.*

v.

DENTON J. REES and KATHRYN G. REES,  
*Appellees.*

---

*On Appeal from the Judgment of the United States  
District Court for the District of Oregon.*

---

**BRIEF FOR THE APPELLANT**

---

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FILED

AUG 25 1961







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The District Court erroneously held the entire payment of \$35,000 to Dr. Rees to be capi- tal gain upon his sale of good will, whereas, in determining this price for good will, the parties took into consideration certain im- permissible elements which were not actu- ally elements of good will, but rather which represented recognition of Dr. Rees' entitle- ment to a greater share of the partnership's ordinary income than the other partners.....	9
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### **OPINION BELOW**

The opinion of the District Court (R. 24-33) is reported at 187 F. Supp. 924.

### **JURISDICTION**

This is a suit instituted against the United States for the recovery of 1955, 1956, and 1957 income taxes paid. The taxpayers filed their returns on or about April 9, 1956, March 29, 1957, and April 15, 1958,



respectively. (R. 14-15.) In addition to the amounts paid with their returns, the taxpayers paid asserted deficiencies for each of the calendar years on December 1, 1958 (R. 33.) The taxpayers filed claims for refund on March 3, 1959, and these were denied on August 24, 1959. (R. 34.) Complaint was filed on October 7, 1959 (R. 3-12, 43) within the time provided in Section 6532 of the Internal Revenue Code of 1954, for recovery of the taxes paid.

Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. Judgment was entered on November 28, 1960. (R. 39-40, 44.) Within sixty days and on January 24, 1961, the United States filed its notice of appeal. (R. 40-41, 45.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

### QUESTION PRESENTED

Did the parties to this contract, which purportedly included a sale of good will by Dr. Rees to Dr. Woods and Dr. Butori, erroneously include as elements of good will certain items which were not properly includible therein, so that part of the \$35,000 received by Dr. Rees was not capital gain upon the sale of good will but simply ordinary income representing his entitlement to a greater share of the partnership income than that of his partners?

## STATUTE INVOLVED

Internal Revenue Code of 1954:

### SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

\* \* \* \* \*

(13) Distributive share of partnership gross income;

\* \* \* \* \*

(26 U.S.C. 1958 ed., Sec. 61.)

### SEC. 1221. CAPITAL ASSET DEFINED.

For purposes of this subtitle, the term “capital asset” means property held by the taxpayer \* \* \*

\* \* \* \* \*

(26 U.S.C. 1958 ed., Sec. 1221.)

## STATEMENT

Denton J. Rees graduated from dental school in 1935 and since then, with the exception of the period he was with the Armed Services from 1941 to 1946, he has continuously practiced his profession in Oregon. In 1953, Dr. Rees' health was poor and his practice had reached the stage where it was difficult for him to carry on without working extra hours and further damaging his health. This, together with the fact that he was finding it practically impossible to take vacations and refresher courses in orthodontia, in



which he was specializing, caused him to consider the advantage of a partnership arrangement with two other orthodontists, Dr. Woods and Dr. Butori. (R. 34.)

Dr. Woods graduated from dental school in 1945 and after his service in the Navy entered the general practice of dentistry in Portland. In the summer of 1947 he commenced taking a special course in orthodontia at the University of Illinois. He received his master's degree in 1949 and immediately began to practice orthodontia in Portland. For a considerable time, he was a part-time instructor of orthodontia at the University of Oregon Dental School. He continued this practice until he was called into the Armed Services during the Korean War in March, 1953 (R. 34-35.)

Dr. Butori graduated from dental school in February, 1946, and after serving in the Armed Forces practiced in Portland from 1948 until October, 1951. At that time he took special training in orthodontia at the University of Washington. He received a master's degree in 1953 and became associated with Dr. Woods in the practice of orthodontia. (R. 35.)

The association of Dr. Woods and Dr. Butori continued until they entered into partnership with Dr. Rees. Dr. Woods and Dr. Butori were well acquainted with Dr. Rees and with the extent of his practice and the fact that he was one of two dentists in Portland who was a member of the American Board of Orthodontia, a very prestigious group. Dr. Woods and Dr. Butori had established a professional reputa-

tion of their own, but felt that they would greatly expedite their advance in the profession and would substantially increase their income if they formed a partnership with Dr. Rees. They had been practicing under a profit-sharing agreement and were not willing to enter into the partnership arrangement with Dr. Rees other than on an equal basis. (R. 35-36.)

During the discussions leading up to the formation of the partnership and the drafting of the agreement, the dentists considered that Dr. Rees should fairly be paid a substantial sum for good will. They considered Dr. Rees' fine reputation, both in their profession and with members of the public, which resulted in many referrals to his office by other dentists and by patients who had received satisfactory treatment. They also considered Dr. Rees' personal contacts, and the benefits which would accrue to them by operating on a clinic basis. The District Court found that they concluded that a fair price for them to pay to Dr. Rees for good will would be \$35,000. (R. 35-36.) There was evidence, cited by the District Court in its findings of fact, that the parties took into consideration the following factors in arriving at the total to be paid for good will (R. 36):

- (1) The professional skill and reputation of Dr. Rees;

- (2) The fact Dr. Rees was grossing approximately \$80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing \$40,000 per year;

- (3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;



(4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;

(5) The suitability of the location of Dr. Rees' office for the practice of orthodontics on a clinic basis.

The contract of sale under which Dr. Rees sold good will to Dr. Butori and Dr. Woods contains the following paragraphs (R. 36-38):

1. Sale of Interest in Business. The Seller shall sell to the Purchasers an interest in and to the practice of the Seller operated in the Selling Building, Portland, Oregon, including the good will of the practice, the lease to the premises, and a like percentage of all furniture, fixtures, supplies and equipment now devoted to said practice, with such changes that occur, up to the date of closing, in the normal course of business operation, and the Seller shall enter into an agreement of copartnership with Purchasers whereby the parties hereto shall share the profits and losses equally.

2. Exclusions. This sale does not include any cash on hand or in banks at the date of closing. Nor does this sale include any accounts receivable due to the respective parties at the date of closing, nor amounts received after date of closing for dental work done prior to the date of closing. For the purpose of this agreement dental work done before the date of closing shall include only so much of the treatment to each patient as shall have been completed before the date of closing.

6. Purchase Price. The purchase price of all the assets referred to in paragraph 1 is \$40,000.00 of which \$35,000.00 is attributable to the good will of Seller's established practice. (See Exhibit "A" attached for detailed breakdown of assets

other than good will). The sum of \$100.00 in cash, or by certified check, shall be paid to the Seller at the time of closing. The balance of \$39,900.00 shall be paid by the purchasers to the Seller in equal monthly installments over a period of 10 years or sooner at the option of the Purchasers, until the unpaid balance of \$39,900.00, without interest shall have been paid in full. . . .

Pursuant to the agreement of sale, Dr. Woods and Dr. Butori paid Dr. Rees \$17,000 in 1955, \$17,000 in 1956, and \$3,000 in 1957, all of which Dr. Rees reported as long-term capital gain from the sale of capital assets. (R. 16-17.) A bill of sale, as provided in the sales agreement, was executed by Dr. Rees when payment was completed. Dr. Woods and Dr. Butori reported their income from the partnership as provided by the terms of the partnership agreement. (R. 38.)

The District Court held that Dr. Rees had sold good will to Dr. Woods and Dr. Butori, and the payments received therefor were capital gain. (R. 38-39.)

### **STATEMENT OF POINT TO BE URGED**

The District Court erred in allowing the parties to this contract, which purportedly included a sale of good will by Dr. Rees to Dr. Woods and Dr. Butori, to include as elements of good will certain items which were not properly includible therein, so that part of the \$35,000 received by Dr. Rees was not capital gain upon the sale of good will but simply ordinary income representing his entitlement to a greater share of the partnership income than that of his partners.



## SUMMARY OF ARGUMENT

In concluding that Dr. Rees sold good will to Dr. Woods and Dr. Butori for \$35,000, the District Court permitted the parties to take into consideration certain elements of the transaction which we believe were not properly includible in good will. To the extent that the District Court permitted the inclusion of good will of these impermissible elements, it is our contention that Dr. Rees actually received ordinary income rather than capital gain. The mere labelling of certain considerations as elements of good will does not automatically make them such. Here the District Court found that among the factors considered by the parties in determining the value of Dr. Rees' good will to be sold were the fact that he had been grossing approximately \$80,000 per year from his individual practice while Dr. Woods and Dr. Butori together had been grossing \$40,000, plus the fact that Dr. Woods, while receiving an equal share of the new partnership's income under the partnership agreement, was actually going to be absent for a year. These are not elements of good will within this Court's definition of the term as "those imponderable qualities which attract the custom of a business." Rather they are recognition of the fact that Dr. Rees was actually entitled to a greater share of the future partnership's income than his less successful (or absent) partners. Such assignment of future income results simply in ordinary income and not capital gain. The other elements considered by the parties in valuing good will

would appear to be relatively minor compared to those which were erroneously included. The judgment should be reversed for the taxpayer's failure to prove what part, if any, of the \$35,000 paid to him, purportedly for good will, was in fact entitled to treatment as such.

### ARGUMENT

**The District Court erroneously held the entire payment of \$35,000 to Dr. Rees to be capital gain upon his sale of good will, whereas, in determining this price for good will, the parties took into consideration certain impermissible elements which were not actually elements of good will, but rather which represented recognition of Dr. Rees' entitlement to a greater share of the partnership's ordinary income than the other parties.**

In concluding that Dr. Rees sold good will to Dr. Woods and Dr. Butori for \$35,000, the District Court permitted the parties to take into consideration certain elements of the transaction which we believe were not properly includible in good will. To the extent that the District Court permitted the inclusion in good will of these impermissible elements, it is our contention that Dr. Rees actually received ordinary income rather than capital gain. It is plain that the parties' mere lumping, under the label of good will, of numerous considerations for which a payment was made does not automatically render the entire payment or any of it a capital expenditure or receipt for good will. *O'Rear v. Commissioner*, 80 F. 2d 473 (C.A. 6th); *Commissioner v. Chatsworth Stations, Inc.*,



282 F. 2d 132 (C.A. 2d); *Horton v. Commissioner*, 13 T.C. 143. Likewise an item labelled as something other than good will may in fact be an element of good will. *Dodge Brothers v. United States*, 118 F. 2d 95 (C.A. 4th); *Masquelette's Estate v. Commissioner*, 239 F. 2d 322 (C.A. 5th). Since the \$35,000 here held to have been paid to Dr. Rees for good will was not comminuted into the amounts attributable to each of the several elements included under the label good will, it is our belief that, if impermissible elements were included, the case must be reversed for the taxpayers' failure to have carried their burden of proving the amount of capital gain to which they were entitled upon the sale of good will. *Commissioner v. Chatsworth Stations, Inc.*, 282 F. 2d 132 (C.A. 2d).

The District Court here cited evidence that the parties took into consideration the following in arriving at the total to be paid to Dr. Rees for good will (R. 36):

- (1) The professional skill and reputation of Dr. Rees;

- (2) The fact Dr. Rees was grossing approximately \$80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing \$40,000 per year;

- (3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;

- (4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;

- (5) The suitability of the location of Dr.

Rees' office for the practice of orthodontics on a clinic basis.

In its opinion the District Court stated (R. 31):

As I read the record in this case, the sum of \$35,000 was agreed upon by the parties as the value of the good will after taking into consideration all of the factors above mentioned.

This statement of the District Court is clearly correct, based upon the testimony of Dr. Rees himself (R. 74, 95-98) and that of Dr. Woods (R. 113-114). However, we believe that the court erred as a matter of law in allowing the parties to take into consideration all of these factors *in determining the value of the good will*. Specifically, we direct this Court's attention to items (2) and (3), i.e., the fact that Dr. Rees was grossing approximately \$80,000 per year while Dr. Woods and Dr. Butori together were grossing only \$40,000 per year, and the absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership. There is no definition of good will of which we are aware which would permit the inclusion of such factors. On the contrary, these are factors which indicate that part at least of the \$35,000 payment to Dr. Rees was in consideration of his future earning power, which was recognized to be greater than that of Dr. Woods and Dr. Butori, plus the fact that Dr. Woods, although sharing the partnership's income equally with the others under the partnership agreement (R. 81), was actually going to be absent for a year (R. 96-97). Payment for such considerations is, we submit, recognition of the fact that the taxpayer is entitled to a greater share of the income of the firm



than his less successful (or absent) partners. *O'Rear v. Commissioner*, 80 F. 2d 473 (C.A. 6th). The effect of increasing Dr. Rees' annual income after formation of the partnership was obtained by spreading out the payments to him over a period of at least three years, viz., \$17,000 in 1955, \$17,000 in 1956, and \$3,000 in 1957. (R. 16-17.) To the extent these payments were made in recognition of Dr. Rees' entitlement to a greater portion of the partnership's income than his younger partners, they represented, simply, ordinary income and not gain from the sale of a capital asset. Cf. *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260; *Hort v. Commissioner*, 313 U.S. 28; *Leh v. Commissioner*, 260 F. 2d 489 (C.A. 9th).

In *Grace Bros. v. Commissioner*, 173 F. 2d 170, 175-176, this Court discussed the meaning of good will and defined it as follows:

It is the sum total of those imponderable qualities which attract the custom of a business,—what brings patronage to the business. Mr. Justice Cardozo, in a famous case has called it “a reasonable expectancy of preference \* \* \* (which) may come from succession in place or name or otherwise to a business that has won the favor of its customers.” *Matter of Brown's Will*, 1926, 242 N.Y. 1, 6, 150 N.E. 581, 582, 44 A.L.R. 510.

The Supreme Court has held it to mean “every positive advantage that has been acquired by the old firm in the progress of its business, whether connected with the premises in which the business was previously carried on, or with the name of the late firm, or with any other matter carrying with it the benefit of the business.” *Menendez v. Holt*, 1888, 128 U.S. 514, 522, 9 S. Ct. 143, 144, 32 L. Ed. 526.

Plainly, the fact that Dr. Rees was grossing \$80,000 per year as compared to \$40,000 for Dr. Woods and Dr. Butori together is not an element of good will within this definition; nor is the absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership. These are not includible among "those imponderable qualities which attract the custom of a business." No one could reasonably be expected to patronize the clinic because Dr. Rees' gross income had been twice as high as that of Dr. Woods and Dr. Butori together (even assuming that that was generally known). Nor is there any reason on this record to suppose that the clinic would gain patronage because Dr. Woods was to be absent for a year. The inclusion of these factors in good will, we submit, is untenable on its face, and clearly not within the understanding of this Court as to the meaning of the term.

While such factors as Dr. Rees' professional skill and reputation, the fact that he had interviewed prospective patients, and the desirable location of his office might be considered as proper elements of good will within this Court's definition (see *Rainier Brewing Co. v. Commissioner*, 7 T.C. 162, 176, affirmed *per curiam*, 166 F. 2d 324 (C.A. 9th); *Webster Investors, Inc. v. Commissioner* (C.A. 2d), decided June 9, 1961 (7 A.F.T.R. 2d 1611, 1613)), certain circumstances here, we submit, show their relatively small value as compared to the elements erroneously considered by the parties and the District Court as parts of good will. Thus, the name of Dr. Rees did not (nor



was it ever intended to) appear in the partnership's title of Portland Orthodontic Clinic (later changed to Portland Orthodontic Group). (R. 90-91.) In fact, the stated purpose of the partnership was not to attract or treat patients by any individual dentist within the partnership, but rather to do it on a clinic basis. Thus, Dr. Rees testified as follows (R. 91, 93, 101):

Q. But the group was referred to and you yourself referred to this group as the Portland Orthodontic Clinic at that time?

A. That is correct.

Q. And it was the discussion of the clinic approach that led to the adoption and formation of this new partnership? A. That is correct.

\* \* \* \* \*

Q. In a word, Dr. Rees, the clinic approach is quite a different approach from the individual professional practitioner approach, is it not?

A. It is.

Q. And in the clinic approach the clients—we do refer to them as clients, do we not?

A. Or patients.

Q. Or patients. Excuse me. The patients come to the group and not to a particular doctor?

A. Once the group has become established that is true.

\* \* \* \* \*

Q. In other words, Doctor, after you started the partnership you comingled [sic] the patients that you all had; isn't that correct?

A. That is correct.

Q. After the partnership was once commenced you may work on some of the patients that had previously been Dr. Butori's and he may work on some that had previously been yours; is that right?

A. We all worked on all the patients, with very few exceptions—maybe two or three per cent that particularly want one Doctor to do it.

We give them this choice, but I would say this has been true from the beginning, that probably 95 percent of the patients we all see and we all work on and we rotate on.

Q. That was part of the negotiations of the agreement, was it?

A. That was one of the principal reasons we went into this, \* \* \*.

Accordingly, it appears that the parties here in fact intended to open a *new* practice known as the Portland Orthodontic Clinic where substantially all patients would be treated interchangeably by all dentists. That, rather than the professional skill and reputation of any single dentist, was intended to constitute the attraction and benefit of the new group. It is also worth noting that, although the desirability of the location of Dr. Rees' office was included as an element of his good will, the group obtained new quarters about a year after forming their partnership. (R. 91.)



## CONCLUSION

In valuing the good will sold by Dr. Rees, the parties to the contract considered factors which are not proper elements of good will. Therefore the value attributed to the good will is necessarily erroneous, and the judgment should be reversed.

Respectfully submitted,

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EDWARD J. GEORGEFF,  
*Assistant United States Attorney.*

AUGUST, 1961.

**APPENDIX**

Table of Exhibits Pursuant to Rule 18(2)(B) as Amended:

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27 through 40B	R. 23	R. 55	R. 55
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Argument:	
The District Court did not err in that it decided the instant case on the basis of three points presented for the Court's determination: (1) May the skill of a professional practitioner, such as a dentist, be bought and sold as good will; (2) must the sale and assignment of good will include the assignment and use of the firm name; (3) must an aggregate of personal and professional considerations discussed in arriving at the value of good will be segregated to avoid the contention of a failure of proof on the exact sum which was paid for good will.....	7
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**JURISDICTION**

This is a suit instituted against the United States for the recovery of 1955, 1956, and 1957 income taxes paid. The taxpayers filed their returns on or about April 9, 1956, March 29, 1957, and April 15, 1958, respectively (R. 14-15). In addition to the amounts



paid with their returns, the taxpayers paid asserted deficiencies for each of the calendar years on December 1, 1958 (R. 33). The taxpayers filed claims for refund on March 3, 1959, and these were denied on August 24, 1959 (R. 34). Complaint was filed on October 7, 1959 (R. 3-12, 43) within the time provided in Section 6532 of the Internal Revenue Code of 1954, for recovery of the taxes paid.

Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1346. Judgment was entered on November 28, 1960 (R. 39-40, 44). Within sixty days and on January 24, 1961, the United States filed its notice of appeal (R. 40-41, 45). Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

### QUESTIONS PRESENTED

1. May the skill and reputation of a professional practitioner, such as a dentist, be bought and sold as good will?

2. May good will be sold or transferred to others without the assignment and use of the firm name to which the good will is alleged to attach?

3. Must the amount denominated as good will in an agreement of sale which represents the agreed value placed upon an aggregate of personal and professional considerations designate the exact amount in dollars and cents attributed to that which is personal and that which is professional in order to avoid the contention that there is a failure of proof of the exact sum paid for good will?

## STATUTE INVOLVED

Internal Revenue Code of 1954:

### SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items:

(2) Gross income derived from business;

\* \* \* \* \*

(13) Distributive share of partnership gross income;

\* \* \* \* \*

(26 U.S.C. 1958 ed., Sec. 61.)

### SEC. 1221. CAPITAL ASSET DEFINED.

For the purposes of this subtitle, the term "capital asset" means property held by the taxpayer \* \* \*

\* \* \* \* \*

(26 U.S.C. 1958 ed., Sec. 1221.)

## STATEMENT

Denton J. Rees graduated from dental school in 1935 and immediately commenced the practice of dentistry in the state of Oregon. With the exception of the period he was with the Armed Services of the United States from 1941 to 1946, Rees has continuously practiced his profession in Oregon. In 1953, Rees' health was poor and his practice had reached the stage where it was difficult for him to carry on without working extra hours and further damaging his health. This, together with the fact that he was finding it prac-



tically impossible to take vacations and refresher courses in orthodontia, in which he was specializing, caused him to consider the advantages of a partnership arrangement with a Dr. Woods and a Dr. Butori, two other orthodontists. Dr. Woods graduated from dental school in 1945 and after his service in the Navy entered into the general practice of dentistry in Portland and continued in practice until the summer of 1947 when he commenced taking a special course in orthodontia at the University of Illinois. He received his Masters degree from that institution and in January 1949, commenced the practice of orthodontia in Portland. For a considerable period of time, he was a part time instructor of orthodontia at the University of Oregon Dental School. He continued this practice until he was called into the Armed Services during the Korean War in March 1953. Dr. Butori graduated from dental school in February 1946, and after serving in the Armed Forces he practiced in Portland from 1948 until October 1951. At that time he took special training in orthodontia at the University of Washington. He received a Masters degree from such institution in 1953 and became associated with Dr. Woods in the practice of orthodontia immediately thereafter. This association continued until the formation of the partnership with Rees. Woods and Butori were practicing under a profit-sharing agreement. They were successful in their practice and were not willing to enter into a partnership arrangement other than on an equal basis. Woods and Butori were well-acquainted with Rees and with the extent of his practice and the

fact that he was one of two doctors in Portland who was a member of the American Board of Orthodontics, a very prestigious group.

During the discussions leading up to the formation of the partnership and the drafting of the agreement, the doctors very thoroughly discussed the fact that it was no more than fair that Rees should be paid a substantial sum for good will. After giving full consideration to Rees' fine reputation, both in their profession and with members of the public, which resulted in a very large number of cases being referred to his office by other dentists and by patients who had received satisfactory treatment, and by taxpayer's own personal contacts, and the benefits which would accrue to them from operating on a clinic basis, they concluded that a fair price for them to pay Rees for good will in entering into this arrangement with him would be \$35,000. At that time both Dr. Woods and Dr. Butori had established a professional reputation of their own, but they felt they would greatly expedite their advance in their profession and would substantially increase their income if they formed a partnership with Rees. Insofar as known, this is the first attempt to practice orthodontia on a clinic basis. The evidence clearly shows that the partnership as formed has been extremely successful.

The contract of sale under which Rees sold good will to Butori and Woods contain the following paragraphs:

"1. Sale of Interest In Business: The Seller shall sell to the Purchasers an interest in and to the practice of the Seller operated in the Selling Build-



ing, Portland, Oregon, including the good will of the practice, the lease to the premises, and a like percentage of all furniture, fixtures, supplies, and equipment now devoted to said practice, with such changes that occur, up to the date of closing, in the normal course of business operation, and the Seller shall enter into an agreement of co-partnership with Purchasers whereby the parties hereto shall share the profits and losses equally.

"2. Exclusions. This sale does not include any cash on hand or in banks at the date of closing. Nor does this sale include any accounts receivable due to the respective parties at the date of closing, nor amounts received after date of closing for dental work done prior to the date of closing. For the purpose of this agreement dental work done before the date of closing shall include only so much of the treatment of each patient as shall have been completed before the date of closing.

\* \* \* \* \*

"6. Purchase Price. The purchase price of all the assets referred to in paragraph 1 is \$40,000.00 of which \$35,000.00 is attributable to the good will of Seller's established practice (See exhibit "A" attached for detailed breakdown of assets other than good will). The sum of \$100.00 in cash, or by certified check, shall be paid to the Seller at the time of closing. The balance of \$39,000.00 shall be paid by the purchasers to the Seller in equal monthly installments over a period of 10 years, or sooner at the option of the Purchasers, until the unpaid balance of \$39,900.00, without interest shall have been paid in full. . . ."

## STATEMENT OF POINTS TO BE URGED

The District Court did not err in that after considering the three points presented for determination (R. 28, 29, 30) the Court, on the basis of the evidence submitted, held that the sum of \$35,000 received by Dr. Rees was in payment for good will as intended by the parties in their agreements.

## SUMMARY OF ARGUMENT

While the appellant seeks to limit its argument largely to question III (R. 30) presented to the Court for decision, the appellees contend the case at bar must be considered on the entire record as submitted to the District Court. For that reason appellees will reiterate a portion of the decision of the Honorable Judge Kilkenney whose opinion, in a large part, was directed to answering the same argument of the defendant in the District Court as is now urged by appellant before this Court.

## ARGUMENT

The District Court did not err in that it decided the instant case on the basis of three points presented for the Court's determination: (1) May the skill of a professional practitioner, such as a dentist, be bought and sold as good will; (2) must the sale and assignment of good will include the assignment and use of the firm name; (3) must an aggregate of personal and professional considerations discussed in arriving at the

value of good will be segregated to avoid the contention of a failure of proof of the exact sum which was paid for good will?

Judge Kilkenny's Opinion relative to the above three points is as follows (R. 28-33):

"Three questions are presented for determination by the Court:

"I. May the skill and reputation of a professional practitioner, such as a dentist, be bought and sold as good will? The contract of sale and the other evidence in the record make it very clear that the parties intended Rees would sell and Woods and Butori would purchase good will. Under Oregon law the courts will try to give effect to the provisions of the contract exactly as the parties intended them. *McKenney v. Buffelen Mfg. Co.*, 9 Cir., 1956, 232 F. 2d 5. A construction of a contract which would make a portion thereof invalid is not favored. *J. C. Millett Co. v. Distillers Distributing Corp.*, 9 Cir., 1956, 258 F. 2d 139.

"Although some courts hold to the contrary, *Carol F. Hall* (1952), 19 T.C. 445, 460, the better-reasoned cases permit a professional man to sell good will and allow capital gains treatment of the sales price. *Rodney B. Horton* (1949) 13 T.C. 143; *Richard S. Wyler*, (1950), 14 T.C. 1251; and *Estate of Masquelette v. Commissioner*, 5 Cir., 1956, 239 F. 2d 322. An actual sale of good will may be treated as such even though it is not specifically mentioned in the contract. *Estate of Masquelette v. Commissioner*, *supra*. *O'Rear v. Commissioner*, 6 Cir., 1935, 80 F. 2d 473, 474, cited by defendant, was decided many years prior to the decisions in the above cases and the statements in the case concerning the sale of good will by a professional man are pure dicta. Defendant urges that Oregon has not decided this question. The Supreme Court of Oregon has held that good will is property. *Kaler v.*



Spady, 148 Or. 206, 24 P. 2d 351; *Levene v. City of Salem*, 191 Or. 182, 229 P. 2d 255. Oregon has recognized the sale of good will by physicians, surgeons, lawyers and dentists. *Thompson Optical Institute v. Thompson*, 119 Or. 252, 262-263, 237 P. 965. Good will is recognized as property which may be owned and disposed of by a partnership. ORS<sup>1</sup> 68.210(3)(b).

“II. Defendant urges that good will can be sold and transferred to others only by assignment and use of the firm name to which the good will is alleged to attach.

“*Masquelette v. Commissioner*, *supra*, is squarely against defendant on this point. In that case the taxpayer had been a successful public accountant for a great many years. He sold his practice, which the court held included good will, even though the contract provided that the purchasers could not use the name *Masquelette* in connection with their accounting practice. On September 22, 1960, the Commissioner concluded to follow such decision to the extent it stands for the proposition that the existence of a transferrable good will may be recognized in connection with the sale of a business or profession, the success of which is not dependent solely on the personal qualifications of the owner, even though such sale does not involve the assignment of the right to the exclusive use of the firm name. Rev. Rul. 60-301, I.R.B., 1960-38, 7. *Masquelette* and the new ruling of the Commissioner are conclusive against the defendant. I hold that professional good will may be bought and sold.

“III. The last point raised by the defendant is that the amount denominated as good will in the agreement of sale represented the agreed value placed upon an aggregate of personal and professional consideration and since the personal was not segregated from the professional, there is a failure

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<sup>1</sup> Oregon Revised Statutes.

of proof on the exact sum which was paid for good will. There is evidence that the parties took into consideration the following in arriving at the total to be paid for the good will:

“(1) The professional skill and reputation of Dr. Rees;

“(2) The fact Dr. Rees was grossing approximately \$80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing \$40,000 per year;

“(3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;

“(4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;

“(5) The suitability of the location of Dr. Rees' office for the practice of orthodontics on a clinic basis.’

“Defendant argues that all of these facts were considered and evaluated as component parts of the final sum of \$35,000 designated as the purchase price of the good will. Defendant then contends that the entire amount paid could not conceivably be classed as gain received from the sale of a capital asset, such as good will, and that the claim must be dismissed for failure of proof under the authority of *Roybark v. United States*, 104 F. Supp. 579, 761-762 (S. D. Cal.), *aff'd* 9 Cir., 1954, 218 F. 2d 164, 166, and *Corn Products Co. v. Commissioner*, 350 U.S. 46, 52. Neither of these cases involved the sale of good will. However, they do announce the legal principle that the taxpayer must show that he has overpaid his tax and must also show the exact amount to which he is entitled.

“As I read the record in this case, the sum of \$35,000 was agreed upon by the parties as the value of the good will after taking into consideration all of the factors above mentioned. The Fifth Circuit



in Masquelette approved the definition of good will by Justice Story as follows:

“ ‘Good will may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.’ ”

“This definition fits the intangible good will which was the subject of the sale for \$35,000. Many factors must be considered, both by the purchasers and by the seller, in arriving at a valuation to be placed on good will. In speaking of the sale of good will, and its tax consequences, Judge Yankwich, in *Grace Bros. v. Commissioner*, 9 Cir., 1949, 173 F. 2d 170, 176, said:

“ ‘In the last analysis, each case depends upon particular facts. And in arriving at a particular conclusion, the trier of the facts must take into consideration all the circumstances proved in the case and draw from them such legitimate inferences as the occasion warrants.’ ”

“There is no claim in this case that any part of the \$35,000 should be allocated to the sale of the tangible assets, such as the office equipment. The defendant concedes that a fair value was fixed on those assets. Defendant’s sole contention is that the parties should not have taken into consideration the professional skill, reputation and earning ability of Dr. Rees, or the earning ability of Dr. Woods or Dr. Butori, the fact that Dr. Woods was going to be absent for a period of 12 months, the reaction of future patients of Dr. Rees and the suitability



of Rees' office for the practice of orthodontics on a clinic basis. Any practical businessman would have discussed those features and most, if not all, would effect the judgment of a practical businessman as to what he would pay for the good will of the business or profession. A business contract must be construed in the light of sound business practice. *E. I. de Pont de Nemours v. Claiborne-Reno Co.*, 8 Cir., 1933, 64 F. 2d 224; *Erie Rwy. Co. v. Ohio Public Service Co.*, 6 Cir., 1932, 62 F. 2d 83.

"The intangible which was bought and sold under the contract of sale and under the testimony was good will within the above definition of that term. The fact that Rees did not sell all of the good will is of no significance. *Masquelette v. Commissioner*, supra, p. 326. \* \* \*"

Notwithstanding the thorough consideration of the problem by the Court, appellant seeks to establish error by contending there is a failure of proof on the part of the appellees since certain items which were discussed are not, in its words, "permissible elements" in arriving at good will. In support of their contention that labeling an item good will does not necessarily render it such, an argument in which the appellees agree, the appellant cites *O'Rear v. Commissioner*, 80 F.2d 473 (C.A. 6th). As pointed out by Judge Kilkenney (R. 28-29), all statements in that decision relative to the sale of good will by a professional man are pure dicta. The case was, in fact, decided by the agreement which by its terms recognized that an older attorney by reason of his conceded excess of value of good will and unearned fees was entitled to a payment of \$25,000 from each of two younger partners. The Court speaking through Justice Simons stated at page 474:

“\* \* \* We confine ourselves, however, to the contracts here involved. They are not contracts for the sale of good will. By their terms they recognize that the taxpayer is entitled by reason of his reputation and experience, or due to the conceded excess of good will and unearned fees, to a greater share of the future income of the firm than his less experienced and younger partners. As a ‘differential’ in the division of fees as yet unearned, they agree to pay him a substantial present consideration \* \* \*”

In the case at bar Dr. Rees recognized that his partners were well qualified (R. 72, 76, 108); he did not consider that he was allocating any of his income to them (R. 76, 77, 78). The partnership now under consideration was brought about because a doctor whose health had been permanently impaired during the Bataan Death March (R. 70) could no longer continue on as he had been doing (R. 70), could not hire orthodontists (R. 71), and as a solution sought a partnership with two other orthodontists who though unwilling to enter into an unequal partnership (R. 72) were willing to enter into a partnership to attempt the practice of orthodontia on a clinic basis (R. 73). It is true that Dr. Rees had an enviable reputation (R. 74, 75, 113) and a potential to acquire patients necessary to make a clinic approach to orthodontia possible (R. 75) even though he had not signed patients for treatment (R. 70, 71). If this had not been so no good will would have existed, *Grace Bros. v. Commissioner*, 173 F.2d 170 (C.A. 9th).

In *Commissioner v. Chatsworth Stations, Inc.*, 282 F.2d 132 (C.A. 2nd), cited by appellant, the Court, unlike the case at bar, was confronted with several agree-

ments purporting to provide for the sale of good will in which no allocation had been made of the purchase price among the various assets sold. The case was remanded to the tax court for further findings. At page 135 the Court stated:

“\* \* \* The taxpayer’s burden in challenging the Commissioner’s allocation is more difficult to sustain where, as here, the parties have made no express allocation of the purchase price \* \* \*”

In the case at bar, there was a complete allocation of the purchase price and appellant, as noted by the District Court (R. 32), did not challenge the correctness of that allocation. The appellant disregards the direct statements of Dr. Rees as to the \$35,000 now in question. Dr. Rees testified as follows (R. 77):

“Mr. Pedersen: Q. All right. Was the figure of \$35,000, Doctor, to compensate you for your experience over and above the experience of the incoming doctors?”

A. I wouldn’t say it was experience. They were competent and well trained. It was to compensate me for the additional patients which I would be able to bring to the group through my sources of reference.

Q. Again, not the ones you had signed up but the ones that were potential patients?

A. The ones I would be able to bring in.

Q. Would you say that the \$35,000, Doctor, was to compensate you for a larger share of the profits?

A. No.

Q. Doctor, summing this up at this point, at the time that you entered into this agreement you felt that you had a potential not signed up that you could get into this clinic approach; is that correct?

A. Yes.”



Likewise, appellant seeks to tie in the difference of the \$80,000 gross income by Dr. Rees prior to the formation of the partnership with the lesser gross by the younger doctors as a major measure of good will. The testimony, however, does not bear this out. Dr. Rees testified as follows on cross-examination by the appellant (R. 96):

“Q. In summing this, Dr. Rees, you did actually make an arithmetical computation; that is true, isn’t it?

A. This was arrived at by a discussion and, you might say, dickering.

Q. Your gross income at that time was approximately \$80,000 a year, Doctor?

A. Yes.

Q. And you discussed that?

A. For the one year. That is, for 1954.

Q. Yes, sir. Approximately \$80,000?

A. Yes.

Q. And that amount was discussed with Dr. Woods and Dr. Butori?

A. Yes. [58]

Q. And their gross amount at that time was approximately \$40,000?

A. Yes.

Q. And you discussed that with the two doctors?

A. Yes.

Q. The difference is approximately \$40,000?

A. Yes.

Q. And it was that difference between these two amounts of gross income that you arrived at in determining the amount of what is called good will here in this instrument?

A. It acted as one factor in the discussions, yes.

Q. It was the big factor, as you so told us, isn’t that true?

A. Well, not necessarily. The amount of money—”

The witness was interrupted by further questions and Dr. Rees further testified relative to the \$80,000 gross on redirect as follows (R. 102):

“Q. Doctor, out of that gross how much did you net?

A. I don't have those figures in front of me here, but I would say probably it was about \$45,000.

Q. After this partnership was commenced was your gross larger or smaller than \$45,000?

A. The first year I believe it was a little bit smaller, but succeedingly it has been as large or larger.

Q. Now, considering, Doctor, the time that you had free to go to clinics, the time that you have taken off for vacations and the time that you have been away from your office, have you expended more or less hours for the income that you have earned in subsequent years?

A. Definitely less hours have been expended in the practice, and then I have had these other advantages with no less income; [65] in fact, a slight increase.

Q. In other words, the partnership has been able to function efficiently, wouldn't you say?

A. Yes.”

The fact that Dr. Woods would be absent from the partnership part of the time (R. 97) while stationed in the armed services at Bremerton, Washington, did not, as appellant contends, figure in the value of good will. Dr. Rees testified on recross-examination by counsel for appellant (R. 105):

“Q. All right. Now, I believe you stated that the first year after the clinic was formed your net income or your gross income was lower?

A. I believe my gross was slightly lower the first year after the partnership.

Q. After that it picked up again? [68]

A. Yes.

Q. And it was after that that Dr. Woods came back to practice, was it not?

A. Yes.

Q. And you didn't have the full benefit of his services during that first year?

A. Correct.

Q. And you knew that at the time this instrument was executed?

A. That is correct.

Q. That was one of the considerations in arriving at the amount for the differential of good will?

A. No, I don't believe it was a main consideration.

Q. It was a consideration, Doctor. You did agree to share your profits—

A. In the fees. Not the fact that there would be one year that he was in the service of the Government and was therefore unable to be there. I mean over the long picture we all expected we had many years of practice left, and this one year—also, we had to take into consideration the good will arising to some extent from him and the work that he was doing. So I mean the lack of his being there—of course, that cut down the gross of the partnership for one year, but I don't think that the fact he was in the service this one year was a major consideration in the amount of money that was received for good will, no."

Appellant disregards the importance of a centrally located office which Dr. Rees had. Dr. Rees testified as follows (R. 78):

"Q. How about your office location at that time? Where were you located?

A. At the same location, the Selling Building.

Q. Would that type of location be necessary?

A. It would with a practice of this type. A one-man practice [36] would probably work well in a



suburban location, where you are drawing from the immediate area. But when you try to get into a larger group, where you are working with a greater flow of patients, then you must be pretty centrally located, because our patients come from all directions. We have patients coming from Alaska and from—

Q. Where did Dr. Butori and Woods have their offices at that time?

A. They were located on the East Side, in the Hollywood District.

Q. Do you feel that you could have maintained this group over there in that area?

A. I don't believe it would have been feasible or worked, because such a large number of patients that came from the West Side of Portland, came from Oswego—that area would be very inconvenient for them.

Q. Now, in 1954 what was the situation so far as rental space was concerned?

A. It was very difficult to obtain."

Appellant belabors the point that a new practice was started by the doctors. After the formation of the partnership, the doctors immediately acquainted themselves with patients of the others (R. 79). The clinic approach to orthodontia was different only in the sense that three doctors consulted as to what treatment would be the most effective (Ex. 40A, 40B), and once a course of treatment was decided upon the techniques used were fairly well established. Dr. Rees testified as follows (R. 80):

"Q. Doctor, would you consider orthodontia a practice so specialized that these patients were coming to you because of a special technique that you had learned to do, or something?

A. No. As I say, there are no secret techniques or mysteries. That is why we all give courses, give

papers, to acquaint the other men with what we know. There are differences in techniques, but probably as of today most of the major graduate schools, and about 65 or 70 per cent of the orthodontists in the United States, are using almost the identical technique that we do. \* \* \*

The main ingredient that was needed to make the clinic approach to orthodontia possible was the ability to acquire patients in sufficient volume. Dr. Rees testified as follows (R. 75):

“Q. Doctor, what had been the result of this—what you had to offer, you felt, was your reputation within this community. You didn’t have patients that were actually signed up in the sense of ready to go to work on, but you had a number of patients, as I get it, that had come to see you and had signed these white slips and were waiting treatment. Is that it?

A. Well, it was obvious from the increase in my practice over the preceding four or five years, and with the expectation that if the public is aware of what you are doing that this trend would continue, I would probably be able to draw enough patients into the office to make this thing function. As a matter of fact, I had more demand for my services at that time than I could—in other words, I would have had to turn people [33] away. I couldn’t take them.”

That Dr. Rees had such a potential is evident from the success of the partnership (R. 102).

To hold as the appellant now contends would require that the Court disregard the express intentions of the parties as shown in their written agreements (Ex. 1, 2, 3, 4, 5) as well as their testimony at the trial and to place thereon a construction contrary to sound business practice.

In *Erie Rwy. Co. v. Ohio Public Service Co.*, 6 Cir., 1932, 62 F.2d 83, cited by the District Court (R. 32), the Sixth Circuit Court of Appeals in speaking of the construction that should be placed upon a contract stated at page 83:

“[2] \* \* \* ‘Business contracts must be construed with business sense, as they naturally would be understood by intelligent men of affairs.’ The Kronprinzessin Cecilie, 244 U.S. 12, 24, 37 S. Ct. 490, 492, 61 L. Ed. 960.”

In *E. I. Du Pont de Nemours & Co. v. Claiborne-Reno Co.*, 8 Cir., 1933, 64 F.2d 224, cited by the District Court (R. 34) the Circuit Court at page 228 stated as follows:

“[8] Contracts are ordinarily to be performed by business men, and should be given the interpretation which would be placed upon them by the business world. \* \* \*”

As pointed out by the District Court (R. 32) in its reference to the statement of Judge Yankwich in *Grace Bros. v. Commissioner*, 9 Cir., 1949, 173 F.2d 170 at 176, each case must rest upon its particular facts. It would be ridiculous to argue that the three doctors should not have discussed those items noted by the Court (R. 30) in arriving at good will—as practical businessmen they were obliged to do so.



**CONCLUSION**

The appellees submit that the District Court having considered this case fully did not err in holding that Dr. Rees sold and Dr. Woods and Dr. Butori purchased good will in the sum of \$35,000. The judgment of the District Court should be affirmed.

Respectfully submitted,

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Portland 4, Oregon.

**APPENDIX**

Table of Exhibits Pursuant to Rule 18(2)(B) as Amended:

<i>Exhibit</i>	<i>Identified</i>	<i>Offered</i>	<i>Received</i>
1 through 12	R. 21	R. 55	R. 55
13 through 26	R. 22	R. 55	R. 55
27 through 40B	R. 23	R. 55	R. 55
41-A	R. 23, 65-66	R. 66	R. 66
41-B	R.23, 66	R. 66	R. 66

No. 17348

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**United States  
Court of Appeals**  
for the Ninth Circuit

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UNITED STATES OF AMERICA,

Appellant,

vs.

DENTON J. REES and KATHRYN G. REES,

Appellees.

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**Transcript of Record**

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Appeal from the United States District Court  
for the District of Oregon

FILED

JUL 20 1961

FRANK H. SCHMID, CLERK





No. 17348

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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The United States District Court  
for the District of Oregon

Civil No. 404-59

DENTON J. REES, and  
KATHRYN G. REES,

Plaintiffs.

v.

UNITED STATES OF AMERICA,

Defendant.

COMPLAINT

The above-named plaintiffs for their complaint allege as follows:

I.

That plaintiffs now are and at all times herein mentioned were husband and wife residing at Route 1, Box 433, Lake Grove, Oregon.

II.

That upon information and belief, on or about the 31st day of October, 1952, R. C. Granquist became the duly appointed and qualified Director of Internal Revenue of the United States for the District of Oregon and continued to act as such until his retirement on or about the 30th day of June, 1959.

III.

That on or about the 9th day of April, 1956, plaintiffs filed, in the office of the Director of Internal Revenue of the United States for the District of Oregon, Portland, Oregon, their income tax return for the

calendar year, 1955, and paid income taxes to said Director as follows: as a carry-over of credit from 1954, \$767.17, on March 31, 1955, \$2,000.00, on June 3, 1955, \$2,000.00, on September 9, 1955, \$2,000.00, on January 10, 1956, \$2,000.00 and on April 9, 1956, \$5,595.18. Thereafter as a result of an audit by the Bureau of Internal Revenue plaintiffs paid additional taxes for the calendar year, 1955, in the amount of \$4,740.23, together with interest.

#### IV.

That on or about the 29th day of March, 1957, plaintiffs filed in the office of the Director of Internal Revenue of the United States for the District of Oregon, at Portland, Oregon their income tax return for the calendar year, 1956, and paid income taxes to said Director as follows: on April 9, 1956, \$3,625.00, on June 12, 1956, \$3,725.00, on September 4, 1956, \$3,725.00, on December 7, 1956, \$3,725.00 and on March 29, 1957, \$3,234.17. Thereafter as a result of an audit by the Bureau of Internal Revenue plaintiffs paid additional taxes for the calendar year, 1956, in the amount of \$6,374.35, together with interest.

#### V.

That on or about the 15th day of April, 1958, plaintiffs filed in the office of the Director of Internal Revenue of the United States for the District of Oregon, at Portland, Oregon, their income tax return for the calendar year, 1957, and paid income taxes to said Director as follows: on March 28, 1957, \$4,500.00, on June 6, 1957, \$5,333.33, on September 6, 1957, \$5,-



333.33, on December 14, 1957, \$5,333.34 less a tax credit in the amount of \$1,026.60 carried to the tax year 1958. Thereafter as a result of an audit by the Bureau of Internal Revenue, plaintiffs paid additional taxes for the calendar year, 1957, in the amount of \$1,929.77, together with interest.

#### VI.

That inasmuch as said Director is no longer in office, this suit is brought against the defendant, United States of America, pursuant to Title 28, United States Code, Section 1346.

#### VII.

This action arises under the laws of the United States providing for internal revenue, as hereinafter more fully appears.

#### VIII.

That at all times herein mentioned the Plaintiff, Denton J. Rees, was and now is a practicing Dentist specializing in Orthodontia as a member of a partnership known as the Portland Orthodontic Group with offices at 1033 S. W. Yamhill Street, Portland, Oregon which partnership maintains its books on a fiscal year and said partnership duly filed its income tax returns with the Director of Internal Revenue at Portland, Oregon for the fiscal year April 1, 1954 to March 31, 1955, April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, and plaintiffs duly reported their one-third share of the profits from said partnership on their income tax returns for the calendar years 1955, 1956 and 1957.

## IX.

That on the 3rd day of March, 1959, plaintiffs duly filed with the Director of Internal Revenue for the District of Oregon, at Portland, Oregon, their refund claims for income taxes paid in respect of the calendar years 1955, 1956 and 1957 claiming refunds in the amounts of \$5,487.43, \$6,996.68 and \$2,002.39 for said years together with such greater amount as was legally refundable with interest. Said claims were rejected by the Director of Internal Revenue under date of August 24, 1959, and plaintiffs were so notified by registered mail. The facts set forth in Paragraphs X to XV hereof, inclusive, were set forth in said refund claims as a ground thereof.

## X.

That during the period April 1, 1955 to December 31, 1955, the Partnership hereinabove referred to in Paragraph VIII deducted as an ordinary, necessary business expense the sum of \$450.00 and credited said amount as rental to taxpayers for the use of that portion of their residence devoted to taxpayer, Denton J. Rees' business and plaintiffs reported said income on their income tax return for the year, 1955, from which plaintiffs deducted the following as ordinary, necessary business expenses against said income: \$616.08 for depreciation, \$35.00 for electricity, \$50.00 for maintenance and \$30.00 for heat; that during the period January 1, 1956 to December 31, 1956, the partnership paid \$600.00 to the taxpayers for the use of their residence, as above alleged, and deducted the same as an ordinary, necessary business expense and plaintiffs reported the same on their income tax return for the year, 1956, and deducted therefrom as ordinary, necessary business

expenses against the income, the following: \$616.08 for depreciation, \$40.00 for heat, \$30.00 for electricity and \$6.00 for water; that during the period January 1, to December 31, 1957, the partnership paid as rental to the taxpayers the sum of \$600.00 for the use of their residence as above alleged and taxpayers reported the same on their tax return and deducted the following as ordinary, necessary business expenses: \$308.02 for depreciation, \$40.00 for heat, \$30.00 for electricity and \$6.00 for water. Upon an audit of the partnership returns for the fiscal years ending April 30, 1955, 1956 and 1957 and the income tax returns of the taxpayers for the calendar years 1955, 1956 and 1957 by the Bureau of Internal Revenue, the Director disallowed the amounts paid by the partnership to taxpayers as rent and the amounts charged by the taxpayers as ordinary, necessary business expenses, against the rental income reported by taxpayers on their income tax returns.

## XI.

That the taxpayers, pursuant to an Agreement of Sale entered into by the taxpayer, Denton J. Rees, as Seller, and Eugene F. Butori and Guy A. Woods, Jr. as Purchasers, on the 28th day of March, 1954, received the sums of \$17,000.00 in 1955, \$17,000.00 in 1956 and \$3,000.00 in 1957, all of which sums the taxpayers reported on their income tax returns for the calendar years 1955, 1956 and 1957 as resulting from the sale of capital assets held for more than six months. Upon an audit of the income tax returns of the taxpayers for the calendar years 1955, 1956 and 1957 and the partnership returns for the fiscal years ending March 31, 1955, 1956 and 1957, by the Bureau of In-



ternal Revenue, the Director disallowed the validity of said Agreement of Sale to the extent that the same provided for the sale of good will and treated that portion of the payments received for goodwill as a reallocation of partnership income to the taxpayer, Denton J. Rees, subject to being treated as ordinary income.

## XII.

That during the fiscal year, April 1, 1955 to March 31, 1956 of the partnership as alleged in Paragraph VIII above, the partnership paid \$400.00 to the taxpayer, Denton J. Rees, to reimburse him for expenses incurred in attending a meeting of the Honolulu Dental Society on behalf of the partnership as a guest lecturer on Orthodontia and deducted the same as an ordinary, necessary business expense. Upon an audit of the partnership return for the fiscal year ending March 31, 1956 by the Bureau of Internal Revenue, the Director disallowed said deduction.

## XIII.

That during the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, the partnership, as alleged in Paragraph VIII above, paid on and for the account of the taxpayer, Denton J. Rees, to the Oswego Country Club and the Multnomah Athletic Club the sums of \$587.03 and \$549.80 incurred by the taxpayer, Denton J. Rees, in furthering the business of the partnership, and the partnership deducted said sums as ordinary, necessary business expenses. Upon an audit of the partnership returns for the fiscal years ending March 31, 1956 and 1957 by the Bureau of Internal Revenue, the Director disallowed said deductions.

## XIV.

That during the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, the partnership as alleged in Paragraph VIII above paid telephone bills for and on behalf of the taxpayer, Denton J. Rees, in the sums of \$84.48 and \$85.47 for expenses incurred by the taxpayers in maintaining a telephone in their residence for business purposes and the partnership deducted said amounts as an ordinary, necessary business expense. Upon an audit by the Bureau of Internal Revenue of the partnership returns for the fiscal years ending March 31, 1956 and 1957, the Director disallowed said deductions.

## XV.

That during the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, the partnership as alleged in Paragraph VIII above reimbursed the taxpayer, Denton J. Rees, in the amounts of \$810.00 and \$822.50 for the use of his personal automobile for business purposes of the partnership and deducted the same as ordinary, necessary business expenses. Upon an audit by the Bureau of Internal Revenue of the Partnership returns for the fiscal years ending March 31, 1956 and 1957, the Director disallowed said deductions in the amount of \$710.00 and \$722.50.

## XVI.

That the plaintiffs allege that the sum of \$14,362.35 for the calendar year, 1955, the sum of \$18,034.17 for the calendar year, 1956, and the sum of \$19,473.40 for the calendar year, 1957, was rightfully assessed in each of said years and collected against them and now allege

that the additional sums of \$4,740.23 for the calendar year, 1955, together with interest of \$747.20, \$6,374.35 for the calendar year, 1956, together with interest of \$622.33, and \$1,929.77 for the calendar year, 1957, together with interest of \$72.62 were wrongfully collected by the Director of Internal Revenue, R. C. Granquist for and on behalf of the defendant, which amounts by reason of the disallowance and rejection of said claims for refund by the successor in office to said R. C. Granquist, to wit, A. G. Erickson, the defendant refused and still refuses to refund to these plaintiffs.

#### XVII.

That the income tax and interest, the refund of which is now claimed and sued for, resulted from the action of the Director of Internal Revenue acting for and on behalf of the defendant (a) in illegally and erroneously denying the allowable deductions as ordinary and necessary business expenses incurred in taxpayer, Denton J. Rees', business and as ordinary and necessary business expenses of the partnership under Section 162 of the Internal Revenue Code of 1954, as amended and extended, (1) of the sums of \$450, \$600.00 and \$600.00 paid and credited by the partnership to taxpayers as rental during the periods ending December 31, 1955, 1956 and 1957, and the deductions taken by the taxpayers in the sums of \$731.08, \$692.08 and \$384.02 against said income for the taxpayers' calendar years 1955, 1956 and 1957; (2) the sum of \$400.00 paid by the partnership during the fiscal year April 1, 1955 to March 31, 1956 to reimburse taxpayer, Denton J. Rees, for expenses incurred on a business trip to Hawaii; (3) the sums of \$587.03 and \$549.80 paid by the part-



nership during the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, for the account of the taxpayer, Denton J. Rees, to the Oswego Country Club and the Multnomah Athletic Club; (4) the sums of \$84.48 and \$85.47 paid by the partnership during the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957 for maintaining a telephone in the residence of the taxpayers for business purposes; (5) the sums of \$710.00 and \$722.50 for the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957 paid by the partnership to or for the account of the taxpayer, Denton J. Rees, for the use of his personal automobile for business purposes; and (b) in illegally and erroneously treating as ordinary income the sale of certain assets which were capital assets as defined by Section 1221 and as such subject to being reported as capital assets held for more than six months as defined in Section 1222 of the Internal Revenue Code of 1954, as amended and extended, in the sum of \$14,875.00 in the calendar year, 1955, \$14,875.00 in the calendar year, 1956, and the sum of \$2,625.00 in the calendar year, 1957, with the result that there was denied to plaintiffs and/or the partnership the deductions set forth in (a) (1), (2), (3), (4) and (5) as ordinary, necessary business expenses in computing the income of the partnership for the fiscal years ending March 31, 1955, 1956 and 1957 and the income of the plaintiffs for the calendar year 1955, 1956 and 1957, and by reason of treating the sums hereinabove set forth in (b) hereof as ordinary income there was denied to plaintiffs in computing their taxable income for the calendar years 1955,

1956 and 1957 the benefit of treating said sums as long term capital gains thereby subject to alternative tax treatment under the Internal Revenue Code.

Wherefore, Plaintiffs demand judgment against the Defendant for the sum of \$5,487.43 for the calendar year, 1955, the sum of \$6,996.68 for the calendar year, 1956, and the sum of \$2,002.39 for the calendar year, 1957, together with interest from the 28th day of November, 1958, the date of the payment of the same, being the amount of taxes and interest thereon illegally collected by the Defendant from the Plaintiffs, and such costs as are allowable herein.

/s/ By A. W. PEDERSEN,  
Attorney for Plaintiffs

Duly Verified.

[Endorsed]: Filed Oct. 7, 1959.

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[Title of District Court and Cause.]

### ANSWER

Defendant for its answer to the complaint filed herein, admits, denies, and states as follows:

1. Admitted.
2. Admitted.
3. Lacks information sufficient to form a belief at this time as to the truth of Paragraph III.
4. Lacks information sufficient to form a belief at this time as to the truth of Paragraph IV.
5. Lacks information sufficient to form a belief at this time as to the truth of Paragraph V.
6. Admitted.
7. Admitted.

8. Lacks information sufficient to form a belief at this time as to the truth of Paragraph VIII.

9. Lacks information sufficient to form a belief at this time as to the truth of Paragraph IX.

10. Lacks information sufficient to form a belief at this time as to the truth of Paragraph X.

11. Lacks information sufficient to form a belief at this time as to the truth of Paragraph XI.

12. Lacks information sufficient to form a belief at this time as to the truth of Paragraph XII.

13. Lacks information sufficient to form a belief at this time as to the truth of Paragraph XIII.

14. Lacks information sufficient to form a belief at this time as to the truth of Paragraph XIV.

15. Lacks information sufficient to form a belief at this time as to the truth of Paragraph XV.

16. Denied.

17. Denied.

Wherefore Defendant asks that the complaint be dismissed together with its costs.

C. E. LUCKEY,  
United States Attorney,  
District of Oregon.

/s/ EDWARD J. GEORGEFF,  
Asst. U. S. Attorney.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed Oct. 9, 1959.



[Title of District Court and Cause.]

### PRE-TRIAL ORDER

This cause came on regularly for pre-trial conference before the Court on February 15, 1960. Plaintiffs appeared by A. W. Pedersen, their attorney, and defendant appeared by C. E. Luckey, United States Attorney for the District of Oregon, and Edward J. Georgeff, Assistant United States Attorney, of its attorneys.

Thereupon the following proceedings were had:

#### Statement of Agreed Facts

1. At all times material hereto plaintiffs were husband and wife, citizens of the United States, and residents of the State of Oregon.

2. On or about the 31st day of October, 1952, R. C. Granquist became the duly appointed and qualified Director of Internal Revenue of the United States for the District of Oregon and continued to act as such until his retirement on or about the 30th day of June, 1959.

3. On or about the 9th day of April, 1956, plaintiffs duly filed their income tax returns for the calendar year, 1955, and paid income taxes to the Director of Internal Revenue as follows: carry-over credits from 1954, \$767.17, on March 31, 1955, \$2,000.00, on June 3, 1955, \$2,000.00, on September 9, 1955, \$2,000.00 on January 10, 1956 and \$5,595.18 on April 9, 1956.

4. On or about the 29th day of March, 1957, plaintiffs duly filed their income tax return for the calendar year, 1956, and paid income taxes to the Director of Internal Revenue as follows: on April 9, 1956, \$3,625.00, on June 12, 1956, \$3,725.00, on September 4,

1956, \$3,725.00, on December 7, 1956, \$3,725.00 and on March 29, 1957, \$3,234.17.

5. On or about the 15th day of April, 1958, plaintiffs duly filed their income tax return for the calendar year, 1957, and paid income taxes to the Director of Internal Revenue as follows: on March 28, 1957, \$4,500.00, on June 6, 1957, \$5,333.33, on September 6, 1957, \$5,333.33, on December 14, 1957, \$5,333.34 less a tax credit in the amount of \$1,026.60 carried to the tax year 1958.

6. The United States of America is a proper party defendant, and this action arises under the laws of the United States.

7. The taxpayer, Denton J. Rees, is a practicing dentist specializing in orthodontia and has a one-third interest in a partnership known as the Portland Orthodontic Group which partnership maintains its books on a fiscal year basis from April 1 to March 31, and said partnership duly filed its tax returns with the Director of Internal Revenue for the fiscal year April 1, 1954 to March 31, 1955, April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957. Plaintiffs reported their one-third share of the profits as reflected on said partnership returns.

8. On the 3rd day of March, 1959, plaintiffs filed their claims for refund of income taxes paid in the calendar years 1955, 1956 and 1957 claiming refunds in the amounts of \$5,487.43, \$6,996.68 and \$2,002.39 together with such amount as was legally refundable with interest and said claims were rejected by the Director of Internal Revenue on August 24, 1959.

9. During the fiscal year April 1, 1955 to March 31,

1956, the partnership deducted as an ordinary, necessary business expense the sum of \$450.00 as a rental of that portion of the residence of the taxpayers claimed by the taxpayers as being devoted to the business of the partnership. Taxpayers reported said payment on their tax return for the calendar year 1955 and deducted therefrom the following as ordinary, necessary expenses chargeable against said income: \$616.08 for depreciation, \$35.00 for electricity, \$50.00 for maintenance and \$30.00 for heat.

During the period January 1, 1956 to December 31, 1956, the partnership paid \$600.00 to the taxpayers for the use of their residence, as above set forth, and deducted the same as an ordinary, necessary business expense. Taxpayers reported the sum of \$600.00 on their income tax return for the year, 1956, and deducted therefrom as ordinary, necessary business expenses chargeable against said income, the following: \$616.08 for depreciation, \$40.00 for heat, \$30.00 for electricity and \$6.00 for water.

During the period January 1, to December 31, 1957, the partnership paid \$600.00 to the taxpayers for the use of their residence, as above set forth, and deducted the same as an ordinary, necessary business expense. Taxpayers reported the sum of \$600.00 on their tax return for the year, 1957, and deducted therefrom as ordinary and necessary business expenses the following: \$308.02 for depreciation, \$40.00 for heat, \$30.00 for electricity and \$6.00 for water.

10. Taxpayers, pursuant to an agreement of sale entered into by the taxpayer, Denton J. Rees, as seller, and Eugene F. Butori and Guy A. Woods, Jr., as pur-



chasers, on the 28th day of March, 1954, received the sums of \$17,000.00 in 1955, \$17,000.00 in 1956 and \$3,000.00 in 1957 which taxpayers reported on their income tax returns for the calendar years 1955, 1956 and 1957 as long term capital gains resulting from the sale of capital assets.

11. During the fiscal year, April 1, 1955 to March 31, 1956, the partnership paid \$400.00 to the taxpayer, Denton J. Rees. Taxpayer claims this amount was paid to reimburse him for expenses incurred in attending a meeting of the Honolulu Dental Society. The partnership deducted the same as an ordinary and necessary business expense.

12. During the fiscal year April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, the partnership paid on account of the taxpayer, Denton J. Rees, to the Oswego Country Club and the Multnomah Athletic Club the sums of \$587.03 and \$549.80, and the partnership deducted the same as ordinary and necessary business expenses.

13. During the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, the Partnership paid residential telephone bills for Taxpayer, Denton J. Rees, in the amounts of \$84.48 and \$85.47 and deducted the same as an ordinary and necessary business expense of the partnership.

14. During the fiscal years April 1, 1955 to March 31, 1956 and April 1, 1956 to March 31, 1957, the Partnership paid the Taxpayer, Denton J. Rees, the amounts of \$810.00 and \$822.50 for his use of his personal automobile.

15. Plaintiffs paid taxes for the calendar years 1955, 1956 and 1957 in the following sum: \$14,362.35, \$18,034.17, \$19,473.40, and the Director of Internal Revenue assessed and Plaintiffs paid in addition thereto the following sums for the calendar years 1955, 1956 and 1957: \$4,740.23 together with interest of \$747.20, \$6,374.35 together with interest of \$622.33 and \$1,929.77 together with interest of \$72.62, and Plaintiffs duly filed claims for refund for said additional payments.

## II.

### Contentions of Plaintiffs

1. The amounts paid the taxpayers by the Partnership as rental for the use of that portion of Taxpayers' residence devoted to the business of the partnership was an ordinary, necessary business expense of the Partnership, and the amounts deducted by Taxpayers against said rental income were ordinary, necessary, business expenses chargeable against said rental income within the meaning of Section 162 of the Internal Revenue Code of 1954, as amended and extended.

2. The entire amounts received by Taxpayers pursuant to that certain Agreement of Sale entered into by the Taxpayer, Denton J. Rees, as Seller, and Eugene F. Butori and Guy A. Woods, Jr. as purchasers should be treated as amounts received from the sale of capital assets held for more than six months thus being taxable as long-term capital gains within the meaning of Sections 1221 and 1222 of the Internal Revenue Code of 1954, as amended and extended.

3. The amount paid by the partnership to reimburse

the Taxpayer, Denton J. Rees, for his trip to Honolulu was an ordinary, necessary business expense of the Partnership within the meaning of Section 162 of the Internal Revenue Code of 1954, as amended and extended.

4. The amounts paid the Oswego Country Club and the Multnomah Athletic Club by the Partnership for and on behalf of the Taxpayer, Denton J. Rees, were ordinary, necessary business expenses of the Partnership within the meaning of Section 162 of the Internal Revenue Code of 1954, as amended and extended.

5. The amounts paid by the Partnership to taxpayers for the use of the telephone in their residence was to reimburse Taxpayers for the use of their telephone for partnership business and as such was an ordinary, necessary business expense of the Partnership within the meaning of Section 162 of the Internal Revenue Code of 1954, as amended and extended.

6. The amounts paid by the Partnership to Taxpayers for the use of the personal car of Denton J. Rees was to reimburse him for the use of said automobile for the business of the Partnership and as such was an ordinary, necessary business expense of the Partnership within the meaning of Section 162 of Internal Revenue Code of 1954, as amended and extended.

### III.

#### Contentions of Defendant

1. The payment made to the Taxpayers by the Partnership and claimed as rental expense by the Partnership was in reality nothing more than a distribution of partnership income to taxpayer.



2. The deductions claimed by taxpayers for use of their residence for storage of partnership records and as an emergency office is not allowable since the residence is primarily personal to taxpayer and no deduction is allowable to taxpayer for personal expenses.

3. Amounts received pursuant to an "Agreement of Sale" entered into by taxpayer and his partners was an allocation of future income to be earned by the partners. The amount of such payment being computed on the gross cash income of taxpayer partners based on the patients available and waiting for treatment. As an agreement for distribution of future income it was ordinary income to taxpayer.

4. The amount of \$400.00 paid to taxpayer upon his return from a trip to Hawaii was a distribution of partnership income to taxpayer and as such was not deductible by the partnership as an ordinary and necessary expense of the partnership business.

5. The amounts paid to Oswego Country Club and Multnomah Athletic Club by the partnership were payments of taxpayers personal obligations and were not deductible business expenses of taxpayers.

6. The amounts paid by the partnership for taxpayers' home telephone is payment of an expense which is primarily personal to taxpayers and is therefore not deductible by the partnership.

7. Amounts paid taxpayer for his automobile is essentially a distribution of partnership income for a personal expense of taxpayer and is hence not deductible by the partnership.

IV.

Exhibits

1. Profit Sharing Agreement between Dr. Guy A. Woods, Jr. and Dr. Eugene F. Butori.
2. Dissolution Agreement between Dr. Guy A. Woods, Jr. and Dr. Eugene F. Butori, dated February, 1954.
3. Agreement of Sale between Dr. Denton J. Rees as Seller and Dr. Eugene F. Butori and Dr. Guy A. Woods, Jr., as Purchasers, dated March 28, 1954.
4. Agreement of Partnership among Dr. Denton J. Rees, Dr. Eugene F. Butori and Dr. Guy A. Woods, Jr., dated March 29, 1954.
5. Partnership Sale and Purchase Agreement among Dr. Denton J. Rees, Dr. Eugene F. Butori and Dr. Guy A. Woods, Jr., dated March 30, 1954.
6. Amendment of Articles of Co-Partnership dated June, 1956.
7. Schedule of Cost of Improvements incurred in 1952 to Residence of Taxpayers Rees.
8. Schedule of rental income and expenses for 1955 covering rent paid by partnership and expenses deducted by taxpayers against said rental income.
9. Schedule of electricity, heat and maintenance incurred by taxpayers for residence during year 1955.
10. Schedule of Rental Expense of Portland Orthodontic Group for fiscal year ending March 31, 1956, as paid to Taxpayers.
11. Schedule of electricity, heat and water incurred by Taxpayers for residence during 1956.
12. Schedule of Rental Income and Expenses charged against the same for the year 1956.

13. Schedule of payments made by Portland Orthodontic Group to Taxpayers and deducted as rental expense during the fiscal year ending March 31, 1957.

14. Schedule of Rental Income and Expenses as reflected on tax return of the Taxpayers during 1957.

15. Schedule of electricity, heat and water incurred by taxpayers on residence during 1957.

16. Schedule of payments made by Portland Orthodontic Group to Taxpayers for fiscal year ending March 31, 1958.

17. Schedule of Income from Sale of Office Equipment and Goodwill received by Taxpayers during 1955.

18. Schedule of Income from Sale of Office Equipment and Goodwill received by Taxpayers during 1956.

19. Schedule of Income from Sale of Office Equipment and Goodwill received by Taxpayers during 1957.

20. Schedule of club dues and expenses at Oswego Country Club and paid by Partnership for the year 1956.

21. Schedule of club dues and expenses at Multnomah Athletic Club for the year 1956.

22. Schedule of club dues and expenses at Oswego Country Club for the year 1957.

23. Schedule of club dues and expenses at Multnomah Athletic Club for the year 1957.

24. Account summary of fees earned through Oswego Lake Country Club and Multnomah Athletic Club for the years 1956 and 1957.

25. Schedule of amounts paid as telephone expense by Portland Orthodontic Group for taxpayers during fiscal year ended March 31, 1956.

26. Schedule of amounts paid for telephone by taxpayers during 1956.



27. Schedule of amounts paid by Portland Orthodontic Group during fiscal year ending March 31, 1957.

28. Schedule of automobile expense as paid on behalf of taxpayers by Portland Orthodontic Group for fiscal year ending March 31, 1956.

29. Schedule of automobile expenses incurred by taxpayer, Denton J. Rees, during the year 1956.

30. Automobile expense summary for year 1956.

31. Schedule of automobile expenses as paid on behalf of taxpayers by Portland Orthodontic Group for fiscal year ending March 31, 1957.

32. Schedule of automobile expenses incurred by taxpayer, Denton J. Rees, during year 1957.

33. Summary of automobile expenses incurred during the year 1957 by taxpayer, Denton J. Rees.

34. Pamphlet from American Journal of Orthodontics, Vol. 39, No. 9, Pages 695-707, September, 1953.

35. Pamphlet from American Journal of Orthodontics, Vol. 41, No. 5, Pages 370-384, May, 1955.

36. Pamphlet from American Journal of Orthodontics, Vol. 36, No. 9, Pages 676-700, September, 1950.

37. Bill of Sale dated June 25, 1958.

38. Letter from Honolulu Dental Society.

39. Convention Expense.

40. Case History.

40A. Demonstration Evid. (Denture Model)

40B. Demonstration Evid (Denture Model)

41A. Temporary Examination Record.

41B. Permanent Examination Record.

Now, Therefore, it Is Hereby Ordered,

The foregoing is the Pre-trial Order agreed upon between the Court and Counsel, and shall not be amend-

ed, except by consent of both parties, or by order of the Court to prevent manifest injustice. It supersedes the pleadings, which are hereby amended to conform hereto and which now pass out of the case.

Approved and Entered at Portland, Oregon this 19th day of May 1960.

/s/ JOHN F. KILKENNY,  
Judge

Approved:

/s/ A. W. PEDERSEN,  
Of Attorneys for Plaintiff

/s/ EDWARD J. GEORGEFF,  
Assistant United States Attorney  
Of Attorneys for Defendant.

[Endorsed]: Filed May 19, 1960.

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[Title of District Court and Cause.]

### OPINION

Kilkenny, J.:

Action for refund of income taxes alleged to have been overpaid for the years 1955, 1956 and 1957. Although many issues were raised under the pre-trial order, the sole question remaining for the Court's determination is whether the amount paid to plaintiffs under the provisions of a sales agreement is entitled to be taxed as capital gain.

Denton J. Rees graduated from dental school in 1935 and immediately commenced the practice of dentistry in the state of Oregon. With the exception of the

period he was with the Armed Services of the United States from 1941 to 1946, Rees has continuously practiced his profession in Oregon. In 1953, Rees' health was poor and his practice had reached the stage where it was difficult for him to carry on without working extra hours and further damaging his health. This, together with the fact that he was finding it practically impossible to take vacations and refresher courses in orthodontia, in which he was specializing, caused him to consider the advantages of a partnership arrangement with a Dr. Woods and a Dr. Butori, two other orthodontists. Dr. Woods graduated from dental school in 1945 and after his service in the Navy entered into the general practice of dentistry in Portland and continued in practice until the summer of 1947 when he commenced taking a special course in orthodontia at the University of Illinois. He received his Masters degree from that institution and in January 1949, commenced the practice of orthodontia in Portland. For a considerable period of time, he was a part time instructor of orthodontia at the University of Oregon Dental School. He continued this practice until he was called into the Armed Services during the Korean War in March 1953. Dr. Butori graduated from dental school in February 1946, and after serving in the Armed Forces he practiced in Portland from 1948 until October 1951. At that time he took special training in orthodontia at the University of Washington. He received a Masters degree from such institution in 1953 and became associated with Dr. Woods in the practice of orthodontia immediately thereafter. This association continued until the formation of the



partnership with Rees. Woods and Butori were practicing under a profit-sharing agreement. They were successful in their practice and were not willing to enter into a partnership arrangement other than on an equal basis. Woods and Butori were well-acquainted with Rees and with the extent of his practice and the fact that he was one of two doctors in Portland who was a member of the American Board of Orthodontics, a very prestigious group.

During the discussions leading up to the formation of the partnership and the drafting of the agreement, the doctors very thoroughly discussed the fact that it was no more than fair that Rees should be paid a substantial sum for good will. After giving full consideration to Rees' fine reputation, both in their profession and with members of the public, which resulted in a very large number of cases being referred to his office by other dentists and by patients who had received satisfactory treatment, and by taxpayer's own personal contacts, and the benefits which would accrue to them from operating on a clinic basis, they concluded that a fair price for them to pay Rees for good will in entering into this arrangement with him would be \$35,000. At that time both Dr. Woods and Dr. Butori had established a professional reputation of their own, but they felt they would greatly expedite their advance in their profession and would substantially increase their income if they formed a partnership with Rees. Insofar as known, this is the first attempt to practice orthodontia on a clinic basis. The evidence clearly shows that the partnership as formed has been extremely successful.

The contract of sale under which Rees sold good will to Butori and Woods contain the following paragraphs:

“1. Sale Of Interest In Business. The Seller shall sell to the Purchasers an interest in and to the practice of the Seller operated in the Selling Building, Portland, Oregon, including the good will of the practice, the lease to the premises, and a like percentage of all furniture, fixtures, supplies, and equipment now devoted to said practice, with such changes that occur, up to the date of closing, in the normal course of business operation, and the Seller shall enter into an agreement of co-partnership with Purchasers whereby the parties hereto shall share the profits and losses equally.

“2. Exclusions. This sale does not include any cash on hand or in banks at the date of closing. Nor does this sale include any accounts receivable due to the respective parties at the date of closing, nor amounts received after date of closing for dental work done prior to the date of closing. For the purpose of this agreement dental work done before the date of closing shall include only so much of the treatment to each patient as shall have been completed before the date of closing.

\* \* \* \* \*

“6. Purchase Price. The purchase price of all the assets referred to in paragraph 1 is \$40,000.00 of which \$35,000.00 is attributable to the good will of Seller's established practice. (See exhibit “A” attached for detailed breakdown of assets other than good will). The sum of \$100.00 in cash, or by certified check, shall be paid to the Seller at

the time of closing. The balance of \$39,900.00 shall be paid by the purchasers to the Seller in equal monthly installments over a period of 10 years, or sooner at the option of the Purchasers, until the unpaid balance of \$39,900.00, without interest shall have been paid in full. . . .”

Three questions are presented for determination by the Court:

I. May the skill and reputation of a professional practitioner, such as a dentist, be bought and sold as good will? The contract of sale and the other evidence in the record make it very clear that the parties intended Rees would sell and Woods and Butori would purchase good will. Under Oregon law the courts will try to give effect to the provisions of the contract exactly as the parties intended them. *McKenney v. Buffelen Mfg. Co.*, 9 Cir., 1956, 232 F. 2d 5. A construction of a contract which would make a portion thereof invalid is not favored. *J. C. Millett Co. v. Distillers Distributing Corp.*, 9 Cir., 1956, 258 F. 2d 139.

Although some courts hold to the contrary, *Carol F. Hall* (1952), 19 T. C. 445, 460, the better-reasoned cases permit a professional man to sell good will and allow capital gains treatment of the sales price. *Rodney B. Horton* (1949) 13 T. C. 143; *Richard S. Wyler*, (1950), 14 T. C. 1251; and *Estate of Masquelette v. Commissioner*, 5 Cir., 1956, 239 F. 2d 322. An actual sale of good will may be treated as such even though it is not specifically mentioned in the contract. *Estate of Masquelette v. Commissioner*, *supra*. *O’Rear v. Commissioner*, 6 Cir., 1935, 80 F. 2d 473, 474, cited



by defendant, was decided many years prior to the decisions in the above cases and the statements in the case concerning the sale of good will by a professional man are pure dicta. Defendant urges that Oregon has not decided this question. The Supreme Court of Oregon has held that good will is property. *Kaler v. Spady*, 148 Or. 206, 24 P. 2d 351; *Levene v. City of Salem*, 191 Or. 182, 229 P. 2d 255. Oregon has recognized the sale of good will by physicians, surgeons, lawyers and dentists. *Thompson Optical Institute v. Thompson*, 119 Or. 252, 262-263, 237 P. 965. Good will is recognized as property which may be owned and disposed of by a partnership. ORS<sup>1</sup> 68.210(3)(b).

II. Defendant urges that good will can be sold and transferred to others only by assignment and use of the firm name to which the good will is alleged to attach.

*Masquelette v. Commissioner*, *supra*, is squarely against defendant on this point. In that case the taxpayer had been a successful public accountant for a great many years. He sold his practice, which the court held included good will, even though the contract provided that the purchasers could not use the name *Masquelette* in connection with their accounting practice. On September 22, 1960, the Commissioner concluded to follow such decision to the extent it stands for the proposition that the existence of a transferable good will may be recognized in connection with the sale of a business or profession, the success of which is not dependent solely on the personal qualifications of the owner, even though such sale does not

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<sup>1</sup>Oregon Revised Statutes.

involve the assignment of the right to the exclusive use of the firm name. Rev. Rul. 60-301, I.R.B., 1960-38, 7. Masquelette and the new ruling of the Commissioner are conclusive against the defendant. I hold that professional good will may be bought and sold.

III. The last point raised by the defendant is that the amount denominated as good will in the agreement of sale represented the agreed value placed upon an aggregate of personal and professional consideration and since the personal was not segregated from the professional, there is a failure of proof on the exact sum which was paid for good will. There is evidence that the parties took into consideration the following in arriving at the total to be paid for the good will:

“(1) The professional skill and reputation of Dr. Rees;

“(2) The fact Dr. Rees was grossing approximately \$80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing \$40,000 per year;

“(3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;

“(4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;

“(5) The suitability of the location of Dr. Rees' office for the practice of orthodontics on a clinic basis.”

Defendant argues that all of these facts were considered and evaluated as component parts of the final sum of \$35,000 designated as the purchase price of the

good will. Defendant then contends that the entire amount paid could not conceivably be classed as gain received from the sale of a capital asset, such as good will, and that the claim must be dismissed for failure of proof under the authority of *Roybark v. United States*, 104 F. Supp, 759, 761-762 (S. D. Cal.), *aff'd* 9 Cir., 1954, 218 F. 2d 164, 166, and *Corn Products Co. v. Commissioner*, 350 U. S. 46, 52. Neither of these cases involved the sale of good will. However, they do announce the legal principle that the taxpayer must show that he has overpaid his tax and must also show the exact amount to which he is entitled.

As I read the record in this case, the sum of \$35,000 was agreed upon by the parties as the value of the good will after taking into consideration all of the factors above mentioned. The Fifth Circuit in *Masquelette* approved the definition of good will by Justice Story as follows:

“Good will may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital stock, funds, or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill, or influence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices.”

This definition fits the intangible good will which was the subject of the sale for \$35,000. Many factors must be considered, both by the purchasers and by the seller, in arriving at a valuation to be placed



on good will. In speaking of the sale of good will, and its tax consequences, Judge Yankwich, in *Grace Bros. v. Commissioner*, 9 Cir., 1949, 173 F. 2d 170, 176, said:

“In the last analysis, each case depends upon particular facts. And in arriving at a particular conclusion, the trier of the facts must take into consideration all the circumstances proved in the case and draw from them such legitimate inferences as the occasion warrants.”

There is no claim in this case that any part of the \$35,000 should be allocated to the sale of the tangible assets, such as the office equipment. The defendant concedes that a fair value was fixed on those assets. Defendant's sole contention is that the parties should not have taken into consideration the professional skill, reputation and earning ability of Dr. Rees, or the earning ability of Dr. Woods or Dr. Butori, the fact that Dr. Woods was going to be absent for a period of 12 months, the reaction of future patients of Dr. Rees and the suitability of Rees' office for the practice of orthodontics on a clinic basis. Any practical businessman would have discussed those features and most, if not all, would effect the judgment of a practical businessman as to what he would pay for the good will of the business or profession. A business contract must be construed in the light of sound business practice. *E. I. du Pont de Nemours v. Claiborne-Reno Co.*, 8 Cir., 1933, 64 F. 2d 224; *Erie Rwy Co. v. Ohio Public Service Co.*, 6 Cir., 1932, 62 F. 2d 83.

The intangible which was bought and sold under the contract of sale and under the testimony was good will

within the above definition of that term. The fact that Rees did not sell all of the good will is of no significance. *Masquelette v. Commissioner*, *supra*, p. 326.

Counsel may prepare appropriate findings and judgment incorporating the subjects covered by this opinion and by the stipulations and agreements of the parties.

[Endorsed]: Filed October 17, 1960.

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[Title of District Court and Cause.]

## FINDINGS OF FACT AND CONCLUSIONS OF LAW

This cause came on for trial before the Honorable John F. Kilkenny, without a jury, and the issues, save and except that involving the sale of good will, having been settled by stipulation, and the sole remaining issue of the sale of good will having been duly tried, the court finds the facts and states its conclusions of law as follows:

### Findings of Fact

1. That the years involved in this suit for refund are the calendar years 1955, 1956 and 1957.
2. That the deficiencies, assessed against the plaintiffs, and paid by the plaintiffs to the Collector of Internal Revenue on December 1, 1958 were in the following amounts:

<u>Year</u>	<u>Tax</u>	<u>Interest</u>
1955	\$4,740.23	\$747.20
1956	6,374.35	622.33
1957	1,929.77	72.62

That the taxpayers duly filed claims for refund for the above amounts with the Director of Internal Revenue for the District of Oregon on the 3rd day of March 1959, and said claims were denied by the Director by registered mail on August 24, 1959, resulting in this suit for refund.

3. Denton J. Rees graduated from dental school in 1935 and immediately commenced the practice of dentistry in the State of Oregon. With the exception of the period he was with the Armed Services of the United States from 1941 to 1946, Dr. Rees has continuously practiced his profession in Oregon. In 1953, Dr. Rees' health was poor and his practice had reached the stage where it was difficult for him to carry on without working extra hours and further damaging his health. This, together with the fact that he was finding it practically impossible to take vacations and refresher course in orthodontia, in which he was specializing, caused him to consider the advantage of a partnership arrangement with a Dr. Woods and a Dr. Burtori, two other orthodontists. Dr. Woods graduated from dental school in 1945 and after his service in the Navy entered into the general practice of dentistry in Portland and continued in practice until the summer of 1947 when he commenced taking a special course in orthodontia at the University of Illinois. He received his master's degree from that institution and in January 1949 and immediately commenced the practice of orthodontia in Portland. For a considerable period of time, he was a part-time instructor of orthodontia at the University of Oregon Dental School. He continued this practice until he was called into the Armed Serv-



ices during the Korean War in March of 1953. Dr. Butori graduated from dental school in February 1946, and after serving in the Armed Forces he practiced in Portland from 1948 until October 1951. At that time he took special training in orthodontia at the University of Washington. He received a master's degree from such institution in 1953 and became associated with Dr. Woods in the practice of orthodontia immediately thereafter. This association continued until the formation of the partnership with Dr. Rees. Dr. Woods and Dr. Butori were practicing under a profit-sharing agreement. They were successful in their practice and were not willing to enter into a partnership arrangement other than on an equal basis. Dr. Woods and Dr. Butori were well acquainted with Dr. Rees and with the extent of his practice and the fact that he was one of two doctors in Portland who was a member of the American Board of Orthodontics, a very prestigious group.

During the discussions leading up to the formation of the partnership and the drafting of the agreement, the doctors very thoroughly discussed the fact that it was more than fair that Dr. Rees should be paid a substantial sum for good will. After giving full consideration to Dr. Rees' fine reputation, both in their profession and with members of the public, which resulted in a very large number of cases being referred to his office by other dentists and by patients who had received satisfactory treatment, and by the taxpayer's own personal contacts, and the benefits which would accrue to them from operating on a clinic basis, they concluded that a fair price for them to pay Dr.

Rees for good will in entering into this arrangement with him would be the sum of \$35,000. There is evidence that the parties took into consideration the following in arriving at the total to be paid for the good will:

“(1) The professional skill and reputation of Dr. Rees;

“(2) The fact Dr. Rees was grossing approximately \$80,000 per year from his individual practice while Dr. Woods and Dr. Butori together were only grossing \$40,000 per year;

“(3) The absence of Dr. Woods during the twelve-month period succeeding formation of the new partnership;

“(4) The number of prospective patients which Dr. Rees had interviewed for possible treatment in the future;

“(5) The suitability of the location of Dr. Rees' office for the practice of orthodontics on a clinic basis.”

At that time of entering into the partnership both Dr. Woods and Dr. Butori had established a professional reputation of their own, but they felt that they would greatly expedite their advance in their profession and would substantially increase their income if they formed a partnership with Dr. Rees. In so far as known, this is the first attempt to practice orthodontia on a clinic basis. The evidence clearly shows that the partnership as formed has been extremely successful.

The contract of sale under which Dr. Rees sold good will to Dr. Butori and Dr. Woods contains the following paragraphs:

"1. Sale of Interest in Business. The Seller shall sell to the Purchasers an interest in and to the practice of the Seller operated in the Selling Building, Portland, Oregon, including the good will of the practice, the lease to the premises, and a like percentage of all furniture, fixtures, supplies, and equipment now devoted to said practice, with such changes that occur, up to the date of closing, in the normal course of business operation, and the Seller shall enter into an agreement of co-partnership with Purchasers whereby the parties hereto shall share the profits and losses equally.

"2. Exclusions. This sale does not include any cash on hand or in banks at the date of closing. Nor does this sale include any accounts receivable due to the respective parties at the date of closing, nor amounts received after date of closing for dental work done prior to the date of closing. For the purpose of this agreement dental work done before the date of closing shall include only so much of the treatment to each patient as shall have been completed before the date of closing.

"6. Purchase Price. The purchase price of all the assets referred to in paragraph 1 is \$40,000.00 of which \$35,000.00 is attributable to the good will of Seller's established practice. (See exhibit "A" attached for detailed breakdown of assets other than good will). The sum of \$100.00 in cash, or by certified check, shall be paid to the Seller at the time of closing. The balance of \$39,900.00 shall be paid by the purchasers to the Seller in



equal monthly installments over a period of 10 years or sooner at the option of the Purchasers, until the unpaid balance of \$39,900.00, without interest shall have been paid in full. . . .”

A bill of sale, as provided in the sales agreement, was executed by Dr. Rees when payment, pursuant to the terms of the contract, was completed. Dr. Woods and Dr. Butori reported their share of the income from the partnership as provided by the terms of the partnership agreement, paid their income tax thereon and made payments pursuant to the contract of sale as agreed between the parties. Dr. Rees treated the receipt of \$35,000 for good will as a capital asset subject to being treated for tax purposes as a long-term capital gain.

### Conclusions of Law

1. The skill and reputation of a professional practitioner, such as a dentist, may create vendible good will, and Dr. Denton J. Rees had established vendible good will.

2. The taxpayer Denton J. Rees, as seller, and Dr. Woods and Dr. Butori, as purchasers as evidenced by their testimony relating to their preliminary negotiations, as well as the written instruments made a part of the record intended to and did bargain for the sale and purchase of good will.

3. In order for there to be a valid sale of good will, it is not necessary that an assignment and use of a firm name to which good will is alleged to attach accompany the sale of good will.

4. Pursuant to the stipulations of the parties at the time of trial, the opinion of the court, and the let-

ter of the Internal Revenue agent entered under date of November 10, 1960, the plaintiffs are entitled to a refund of taxes as follows: For the tax year 1955, \$5,422.74; for the tax year 1956, \$6,961.09 and for the tax year 1957, \$1,923.45 together with interest at 6 percent per annum from the 1st day of December 1958.

Dated this 28th day of November, 1960.

/s/ JOHN F. KILKENNY,  
District Judge

Receipt of Copy.

[Endorsed]: Filed Nov. 28, 1960.

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United States District Court  
District of Oregon  
Civil No. 404-59

DENTON J. REES and KATHRYN G. REES,  
Plaintiffs,  
v.  
UNITED STATES OF AMERICA,  
Defendant.

### JUDGMENT

The issues in the above-entitled cause having been regularly brought on for trial before the Honorable John F. Kilkenny, without a jury, the parties having appeared in person and by their respective counsel, and the issues, save and except that involving the sale of good will, having been settled by stipulation, and the

sole remaining issue of the sale of good will having been duly tried, and the Court having filed its opinion on the 17th day of October 1960, and the parties pursuant thereto having reached an agreement as to the amount to be refunded to plaintiffs pursuant to the stipulations of the parties and the opinion of the Court, and Findings of Fact and Conclusions of Law having been duly filed, now, therefore, in compliance with said opinion directing judgment, it is

Ordered, Adjudged and Decreed that plaintiffs recover of the defendant the sum of \$5,422.75 for the tax year 1955, the sum of \$6,961.09 for the tax year 1956 and the sum of \$1,923.45 for the tax year 1957, together with interest at six percent per annum from the 1st day of December 1958.

Dated this 28 day of November 1960.

JOHN F. KILKENNY,

Receipt of Copy.

[Endorsed]: Filed Nov. 28, 1960.

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[Title of District Court and Cause.]

NOTICE OF APPEAL

To: Denton J. Rees and Kathryn G. Rees, Plaintiffs,  
and A. W. Pedersen, their attorney.

Notice is hereby given that United States of America, Defendant, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the Judgment entered in this action on November 28, 1960, in favor of plaintiffs and against the defendant.



Dated this 24th day of January, 1961, at Portland, Oregon.

C. E. LUCKEY,

United States Attorney

District of Oregon

/s/ By EDWARD J. GEORGEFF,

Assistant United States Attorney

Of Attorneys for Defendant.

[Endorsed]: Filed Jan. 24, 1961.

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[Title of District Court and Cause.]

ORDER EXTENDING TIME

This matter coming on to be heard ex parte upon motion of defendant for an order extending time for the filing of the record on appeal and docketing the within action in the United States Court of Appeals for the Ninth Circuit to enable The Solicitor General to have additional time to consider said appeal, and the court being fully advised in the premises,

It Is Ordered that the time for filing the record on appeal and docketing the within action be and it is hereby extended to 90 days from January 24, 1961, the date of filing of the Notice of Appeal.

Dated at Portland, Oregon this 2nd day of March 1961.

WILLIAM G. EAST,

Judge

Presented By:

/s/ EDWARD J. GEORGEFF

Assistant United States Attorney

Of Attorneys for Defendant.

[Endorsed]: Filed March 2, 1961.

[Title of District Court and Cause.]

STIPULATION FOR TRANSMITTAL  
OF EXHIBITS

Come now the Appellant, United States of America, appearing by and through C. E. Luckey, United States Attorney for the District of Oregon, and the Appellees, Denton J. Rees and Kathryn G. Rees, appearing through their attorney, A. W. Pedersen, and stipulate, subject to the approval of the Court, that all exhibits in the above-entitled cause may be transmitted in their original form to the Court of Appeals for the Ninth Circuit.

Dated this 21st day of April, 1961.

C. E. LUCKEY,  
United States Attorney  
District of Oregon

/s/ By EDWARD J. GEORGEFF,  
Asst. U. S. Attorney  
Of Attorneys for Appellant

/s/ By A. W. PEDERSEN,  
Attorney at Law  
Attorney for Appellees.

Presented By:

/s/ By EDWARD J. GEORGEFF,  
Ass't U. S. Attorney

It Is So Ordered:

This 21st day of April, 1961.

/s/ GUS J. SOLOMON  
District Judge

[Endorsed]: Filed April 21, 1961.

[Title of District Court and Cause.]

### DOCKET ENTRIES

Attorneys for Plaintiff: A. W. Pedersen, 611 Failing Building, Portland 4, Oregon.

For Defendant: C. E. Luckey, US Atty., Edward J. Georgeff, Asst. US Atty.

Call Date: December 21, 1959

Statistical Record	Costs	Date 1959	Name or Receipt No.	Rec.	Disb.
J.S. 5 mailed 11-5-59-U.S. Clerk		10/7	E 38113	15.00	
J.S. 6 mailed 12-2-60-U.S. Marshal		"	Treas.		15.00
Basis of Action: Refund of Income Tax	Docket fee				
Action arose at:	Witness fees				
	Depositions				

1959

Oct 7 Filed Complaint

7 Issued Summons—to Marshal

9 Filed summons with marshal's return

9 Filed answer

Dec 21 Entered Order setting for pretrial conference February 15, 1960

1960

Feb 15 Entered Order setting for pretrial conference March 21, 1960, at trial week of April 18, 1960 K

29 Entered Order setting for pretrial conference May 16, 1960, at 10:30 A.M. Notified K

Apr 18 Entered Order setting for trial on May tax docket commencing May 16, 1960 SK

May 11 Lodged pretrial order



- |         |  |     |   |
|---------|--|-----|---|
| 19      | Filed and entered pretrial order   | G-I | K |
| 19      | Record of jury trial   |     | K |
| 19      | Entered order that all exhibits listed in pre-trial order be admitted & received   |     | K |
| 19      | Entered order that plaintiff file brief within 30 days; Govt. file answering brief within two weeks thereafter and plaintiff file reply brief within 10 days thereafter; entered order taking under advisement                   |     | K |
| June 15 | Filed plaintiffs' brief in support of plaintiffs' contention that Denton J. Rees bargained for and sold good will  |     |   |
| Aug 25  | Filed brief for the defendant  |     |   |
| 26      | Filed Transcript of Proceedings dated May 19, 1960   |     |   |
| Sept 14 | Filed plaintiffs' reply brief  |     |   |
| Oct 17  | Record of opinion  |     | K |
| 17      | Entered order to file opinion  |     | K |
| 17      | Filed opinion  |     | K |
| 25      | Mailed copy of opinion to Attorney General, Washington, D. C.  |     |   |
| Nov 28  | Filed and entered Findings of Fact and Conclusions of Law  |     | K |
| 28      | Record of hearing on objections to findings  |     | K |
| 28      | Filed and entered judgment that plaintiffs recover of the deflt. the sum of \$5,422.75 for the tax year 1955, the sum of \$6,961.09 for the tax year 1956 and the sum of \$1,923.45 for the tax year 1957, together with int. at |     |   |

six percent per annum from the 1st day of  
Dec. 1958 K

1961

Jan 24 Filed Notice of appeal by defendant.

24 Mailed copy of Notice of appeal to A. W.  
Pedersen, Attorney for plaintiffs

Mar 2 Filed deft's motion for extension of time to  
docket appeal

2 Filed and entered order extending time to 90  
days from Jan. 24, 1961 within which deft.  
may docket appeal E

Apr 19 Filed Designation of Contents of Record on  
Appeal by defendant

21 Filed Stipulation for transmittal of exhibits  
to C of A

21 Filed and Entered Order to transmit orig-  
inal exhibits to C of A (On Stipulation) S

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[Title of District Court and Cause.]

#### CLERK'S CERTIFICATE

I, R. DeMott, Clerk of the United States District Court for the District of Oregon, do hereby certify that the foregoing documents consisting of Complaint, Answer, Pre-trial Order, Opinion, Findings of Fact and Conclusions of Law, Judgment, Notice of Appeal, Order extending time to docket appeal, Designation, Stipulation for transmittal of Exhibits, with Order thereto and Transcript of docket entries, constitute the record on appeal from a judgment of said court in a cause

therein numbered Civil 404-59, in which the United States of America is the defendant and appellant, and Denton J. Rees and Kathryn G. Rees, are plaintiffs and appellees; that the said record has been prepared by me in accordance with the designation of contents of record on appeal filed by the appellant, and in accordance with the rules of this court.

I further certify that there is enclosed herewith reporter's transcript of testimony, dated May 19, 1960, filed in this office in this case, together with one large brown envelope containing plaintiffs' exhibits numbered 1 to 4, inclusive; and 6 to 41, inclusive. Plaintiffs' exhibits number 40 (a) and (b) are being mailed under separate cover.

In Testimony Whereof I have hereunto set my hand and affixed the seal of said court in Portland, in said District, this 21st day of April, 1961.

R. DE MOTT, Clerk

[Seal]            /s/ By MILDRED SPARGO  
Deputy Clerk.

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United States District Court

District of Oregon

Civil 404-59

DENTON J. REES and KATHRYN S. REES,  
Plaintiffs,

vs.

UNITED STATES OF AMERICA,  
Defendant.

Portland, Oregon, May 19, 1960.

Before:

Honorable John F. Kilkenny, Judge.

Appearances:

Mr. Adolph W. Pedersen, Attorney for Plaintiff.

Mr. Arthur L. Biggins, Tax Attorney, Trial Section, Department of Justice, of Attorneys for Defendant.

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### TRANSCRIPT OF PROCEEDINGS

The Court: Are the parties and Counsel ready in Rees vs. United States, No. 404-59?

Mr. Pedersen: The plaintiff is ready, your Honor.

Mr. Biggins: The Government is ready, your Honor.

The Court: I have read the pre-trial order and I think I [1]\* understand the issues. However, if Counsel want to make a further statement, opening statement, you may proceed to do so.

Mr. Pedersen: The plaintiff will waive an open-

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\*Page number appearing at top of page of Original

ing statement, your Honor, on the ground that I think as we progress the exhibits will be almost self-explanatory.

Mr. Biggins: I don't believe an opening statement would be helpful unless the Court desires it at this time.

The Court: All right. Mr. Pedersen, you may proceed.

Mr. Pedersen: We will call Dr. Rees as our first witness.

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DENTON J. REES,

the Plaintiff herein, was produced as a witness in his own behalf and, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Pedersen:

Mr. Biggins: Do you just want to identify your exhibits?

Mr. Pedersen: Yes, I want to identify them and introduce them in evidence and have him testify from them, because then I think we will have the story that we can tie in with his testimony.

Mr. Biggins: I was simply going to stipulate that they are true summaries from the records, your Honor, but Counsel has [2] a different idea of development, so excuse me for interrupting.

The Court: Have these been marked?

Mr. Pedersen: Yes.

Q. May I ask you, Doctor, what your profession is and what do you specialize in.

(Testimony of Denton J. Rees.)

A. I am an orthodontist, which is the specialty of dentistry involving the straightening of teeth.

Q. You have been handed Exhibits 7, 8, 9, 10, 11, 12, 13, 14 and 15. Now, looking at Exhibit 7, Doctor, what does that exhibit show?

A. Well, this is a list of expenses that were involved in remodeling a garage that was adjacent to my home for an office and storage area.

Q. How much was the total of that?

A. \$3,082.67.

Q. Why was this remodeling done, Doctor?

A. Well, I did it in order to have an area where I could see patients that lived near or adjacent to my home, and in emergencies or for examination or minor adjustments that would prevent them from having to come into the office at Portland, a distance of about 12 or 13 miles.

Q. Is there a separate entrance to that addition, Doctor?

A. There is.

Q. Now, the patients you see there, are those patients seen during times that your Portland office is not open? [3]

A. That is correct.

Q. Why, Doctor, is it necessary to see patients there rather than in Portland?

A. Well, primarily it is a matter of emergency. We are dealing with children with appliances in the mouth, and often these appliances are broken or distorted so that it is dangerous to the child to leave it that way.

Q. Is there a danger of infection, Doctor?

A. Infection or—

Q. If they are not immediately taken care of?



(Testimony of Denton J. Rees.)

A. —or swallowing pieces of the appliance. Also, many of these children, both parents work, and the locations of the schools in the area make it very difficult for a child to get into Portland through any public transportation.

Q. How many patients would you say were being treated, that is, being treated by the partnership, during the years 1955, '56 and '57, in Oswego, Dr. Rees?

A. I would say that the average cases, reading from that list, was somewhere in the neighborhood of 100 children.

Q. Doctor, in addition to seeing the patients for emergencies, when braces have been broken, or seeing patients in off-hours, do you utilize your home for any other purposes associated with your business?

A. Well, the case records and files on work that has been completed have to be stored, and I use—[4]

Q. Just a moment, Doctor. I have handed you Exhibits marked for identification, I believe, 40-A, 40-B and 40-C. Now, Doctor, would you explain the two white boxes. What are those?

A. These are boxes that contain the plaster casts.

Q. Would you take them and show them to the Court. Set them up on top so the Court can see them. Is that the kind of cast that you take of your patients?

A. Of each patient, yes. There is usually several progress casts and usually one at the completion of the work.

Q. In addition to that, what other records do you maintain on each patient?

(Testimony of Denton J. Rees.)

A. Well, there are usually X-rays of the mouth, X-rays of the head, taken at various stages. There are physical histories, treatment records, and photographs.

Q. Is that pamphlet there indicative of the typical patient records that are kept?

A. Yes, this is the photographs and X-rays.

Q. Doctor, how long are those records kept for each patient?

A. They almost have to be kept indefinitely. I think legally we are bound to keep them at least five years after the completion of the work, but often these patients will return at a later time.

Q. In the event that a patient returns, comes back to you for some purpose, do you refer to the earlier records?

A. If there was a question of whether there was any change in [5] their mouth or teeth from the time the work was completed. Unless you had these there would be no way of judging except just by what you remembered.

Q. How many records, Doctor, do you presently have or did you have in your home during 1955, '56 and '57?

A. I would say around 1500 to about—

Q. 1500 individual patients? A. Yes.

Q. Could you have kept those records in your Portland office?

A. With the active cases there, there is not room to keep these, the completed ones. I mean there just isn't storage room possible in the office.

Q. Did you try to obtain private storage facilities?

(Testimony of Denton J. Rees.)

A. Well, we discussed it, but they would have to be kept in active storage, and then it would be hard to—these have to be available. If an office patient makes an appointment and there is any question about the work that was done, we have to get these records out and consult them, and unless it was in live storage we would not be able to do so, and then they are not available at all times.

Q. So you have to store these records at your home; that is, the surplusage from the office? Is that the only practical way you can do it? A. Yes.

Q. You would say, then, it would not be possible to keep these [6] records in dead storage at any place as distinguished from live storage? A. No.

Q. Now, Doctor, in addition to using that section of your home for the storage of records and seeing patients at off-hours, do you use that portion of your residence for any other business purpose?

A. I have used it—I keep some library there, and I have given a number of clinics and papers, and most of these I have prepared there because—

Q. If you didn't do that there, you would have to come to your Portland office; is that right?

A. I would have to, yes.

Q. Refer to the next exhibit, Doctor, which shows the rental income and expense for 1955. Could you explain what that exhibit is, just briefly, for the Court.

A. Well, the rental income for the year 1955 is \$450, which is \$50 a month. The partnership was not formed until March, I believe. This was a \$50-a-month allowance.



(Testimony of Denton J. Rees.)

Q. So the partnership paid you \$50 a month for the use of your home?

A. The expenses are as listed, depreciation, electricity, maintenance—

Q. Those expenses on that Exhibit No. 9 that are indicated as electricity, heat, maintenance, were those the total amount [7] expended for your house during that year?

A. No, this was the office area, which is roughly one-seventh of the house area.

Q. Look at that exhibit, Doctor, that is marked Exhibit No. 9. Would you look at that?

A. This is Exhibit 8. I am sorry—

Q. Look at No. 9. Now that shows—

A. This is the total for the house; that is correct.

Q. You have charged against that for business purposes what percentage?

A. One-seventh.

Q. That is how you arrived at the amount that you charged against heat, electricity and maintenance? That is one-seventh of the house; is that right?

A. Yes, sir.

Q. Have you done the same thing for the year 1956? Will you look at Exhibit No. 10 and No. 11 and No. 12. Are those exhibits similar to what you have prepared or which have been prepared for 1955?

A. Yes.

Q. And for the year 1957, looking at Exhibits 13, 14 and 15, are those similar? A. Yes.

Q. Doctor, you have taken depreciation there on a five-year basis. Why did you choose five years on that? [8]

(Testimony of Denton J. Rees.)

A. Well, the residence is approximately twenty years old.

Q. Twenty years old when the improvement was made?

A. When the improvement was made, and the life-time expectancy would be roughly, with depreciation, twenty-five years, so we took it on a five-year basis.

Q. Are any of the patients, Doctor, that are seen at your home your own private patients as distinguished from partnership patients? A. No.

Q. Do you feel, Doctor, that this expenditure was ordinary and necessary in the conduct of the partnership business? A. Yes, sir.

Q. Do you feel it was ordinary and necessary in the conduct of your practice of orthodontia?

A. Yes.

Q. Do you have any idea, Doctor, of the volume of the partnership business that was in the Oswego area during 1955, '56 and '57 which had access to this office?

A. I would say roughly about a fourth or a fifth of the total patients of the office were from that general area.

Q. During the years 1955, '56 and '57 would it have been possible for you to have conducted the business that you conducted at your home office at your Portland office? A. Yes.

Q. Would it have been more expensive or less expensive? [9] A. I believe it would.

Q. It would have been what?

A. More expensive.

(Testimony of Denton J. Rees.)

Q. More expensive, yes. Now, the next item, Doctor, is telephone expense.

The Court: I don't think these exhibits have been offered yet, Mr. Pedersen. Certainly they have not been received.

Mr. Pedersen: All right. I will offer these exhibits at this time in evidence, your Honor.

Mr. Biggins: If I may suggest it, Mr. Pedersen, if you will make an offer of all of the exhibits marked at this time, we will offer no objection.

Mr. Pedersen: All right. We will do that, your Honor.

The Court: Then all of the exhibits identified in the pre-trial order—

Mr. Biggins: The Government has no objection.

The Court: Very well. Then all the exhibits identified in the pre-trial order, being Nos. 1 to 40, inclusive, are admitted in evidence.

(The documents above referred to, as identified in the Pre-Trial Order, were received in evidence as Plaintiffs' Exhibits 1 to 40, inclusive.)

Mr. Pedersen: Q. Doctor, you have been handed Exhibits 25, 26 and 27. Would you explain to the Court briefly what they relate to. [10]

A. These are telephone expenses that were charged to the partnership for a telephone in my residence.

Q. Do you feel, Doctor, that it is necessary that you have a phone in your residence?

A. Absolutely.

Q. Why?



(Testimony of Denton J. Rees.)

A. Well, I have to be available to patients, not only during office hours but in the evening and on week ends in case of emergency. Even after you have worked on a child during the day, the parents may want to call you about—if they are employed and can't come to the office—about the progress of the work.

Q. Do you ever have to go to the hospital on an emergency, Doctor?      A. Yes.

Q. Why is that occasioned?

A. Well, with a large number of children in your practice, they often have broken legs or arms, and we have had some that have had rheumatic heart conditions, or sometimes fractures—they are hit in the mouth with baseball bats or fall off bicycles—

Q. You feel, then, it is just necessary that you have a phone in your home?

A. You must be available.

Q. Now, Doctor, would you look at Exhibit No. 26 and indicate what the total phone bill was for 1956. [11]

A. In my residence phone the total phone bill was \$279.70.

Q. Out of that how much did you charge to business use?      A. \$77.44.

Q. During the year 1957 how much was the total phone bill?

A. 1957? \$295.60.

Q. Out of that you charged how much?

A. \$85.47.

Q. Now, Doctor, the amounts that you have charged each month have been constant. What part

(Testimony of Denton J. Rees.)

of the phone bill have you charged to business?

A. Just the basic residential rate.

Q. Just the residential rate. Have you checked the cost of a business phone?

A. Yes. It would be substantially higher.

Q. So the only thing that you are charging now is the base rate of a phone in your residence?

A. That is right.

Q. Did you use a phone for business purposes during 1956 and '57?

A. Oh, yes.

Q. And the business again, was that of the partnership as distinguished from your own private business?

A. I have no private patients. All patients are patients of the partnership.

Q. Did you charge any personal or long-distance phone calls [12] to that business? A. No.

Q. Doctor, the next bit of evidence is on the trip that you made to Honolulu. You have been handed Exhibit No. 39, a letter from the Dental Society in Hawaii, and a schedule of expenses on this Honolulu trip. Did you make a trip to Hawaii? A. Yes.

Q. In what year was that? A. 1955.

Q. Why did you go to Hawaii in 1955? Why did you make this particular trip?

A. Because I had been invited by the Honolulu Dental Society to present a clinic there in regard to some work that I had published the year before in the American Journal of Orthodontists. These men are isolated pretty well out there, and are always anxious to have somebody come and—

(Testimony of Denton J. Rees.)

Q. Was this trip discussed with members of the partnership? A. Yes.

Q. Were they agreeable that you go?

A. Yes.

Q. You devote a considerable amount of your time, don't you, Doctor, to giving lectures at various places?

A. Yes.

Q. Why do you do that?

A. Well, I think it is considered the ethics in all medical, [13] dental and probably legal professions that any material or advances in the science are to be afforded to other members of the profession. That is how we all have learned, and certainly gained, from other men and their knowledge.

Q. In addition to that, Doctor, looking at it from an economic standpoint, do you gain any business by going to these conventions?

A. I think you naturally gain prestige, and in doing this you meet men in the profession, not only dentists but other orthodontists, and if they know you and believe that you are a man of ability, if they have patients that move to this area, they usually refer them to you.

Q. How many patients have you been able to trace, Doctor, from the contact in Hawaii in 1955?

A. Approximately about ten.

Q. Ten of them came to the Mainland. Of those ten, Doctor, what was the average gross fee?

A. Well, I imagine it would be about \$6,000.

Q. That you have derived from that?

A. Yes.

Q. Would you look at that next exhibit. How



(Testimony of Denton J. Rees.)

much did you expend on this Hawaiian trip?

A. I charged \$400 to the partnership for the trip.

Q. That was to reimburse you for expenses that you had paid out? [14]

A. That is correct.

Q. Now, Doctor, your family went with you on that trip; is that correct?

A. That is correct.

Q. How long did you stay in Hawaii so far as this business for which you went was concerned?

A. Well, I was about four days, was the time involved with the meeting, and meeting with the orthodontists and the time spent in their offices.

Q. And you presented your paper; is that right?

A. That is right.

Q. Were any of those expenses, Doctor, incurred after this four-day period?      A. No.

Q. And are any of those expenses listed on there those of your wife and the members of your family?

A. No.

Q. They are limited only to you?

A. Correct.

Q. How long did you stay in Hawaii after this was over?

A. I stayed a month altogether—three weeks after this.

Q. Three weeks after this was over. And so far as you are concerned, the amount that has been charged to the partnership would be the same if you had flown over and flown right back; is that right? [15]

A. That is right.

(Testimony of Denton J. Rees.)

Q. The next item, Doctor, is the use of your personal car. I might ask you, Doctor, just one thing: Would you consider that the expenses of the Hawaiian trip were ordinary and necessary expenses for the partnership? A. Yes.

Q. Is it necessary, Doctor, that you have an automobile in your business? A. Yes.

Q. Would you explain to the Court how this automobile is used in your business.

A. Well, I have been associated with the University of Oregon on the staff and as a consultant there with the Hospital for Crippled Children; also conferring with other dentists about patients. And in order to see patients in the hospital or when they are confined to their homes—

Q. Could you do that without an automobile, Doctor? A. No.

Q. You could ride in taxicabs, couldn't you?

A. It would be difficult from the area in which I live, and at times impossible.

Q. Doctor, look at those schedules of automobile expense summarized for 1956. What does that show?

The Court: What exhibit are you referring to?

Mr. Pedersen: That is Exhibit No. 28. [16]

The Court: If you will keep the exhibit number in mind, Mr. Pedersen, when you ask these questions, then the record will be clear.

Mr. Pedersen: Thank you.

The Witness: Would you repeat the question?

Mr. Pedersen: Q. What does Exhibit No. 28 indicate, Doctor?

(Testimony of Denton J. Rees.)

A. It shows the automobile expenses for 1956.

Q. Is there a summary of expenses for 1956?

A. Yes.

Q. Now, out of the automobile expenses shown on that schedule, \$2,100.18—is that the right exhibit?

A. No. Exhibit 28 is the expenses I charged to the partnership for the use of the automobile.

Q. What is the total of that?

A. \$810.

Q. \$810?

A. \$810.

Q. How were those expenses arrived at, Doctor?

A. By keeping a record of the mileage in which the car was used that was for business of the partnership.

Q. What charge per mile was made for that?

A. Ten cents.

Mr. Pedersen: If I may approach the witness, your Honor, I want to look at Exhibit No. 30. [17]

Q. Doctor, what does that breakdown indicate?

A. This was the total expenses and depreciation on the automobile that I used for business purposes for the year 1956.

Q. What was the total expense of that automobile?

A. \$2,108.18.

Q. You have charged how much, Doctor, for the use of a car?      A. \$810.

Q. That roughly amounts to 39 per cent or one-third of one automobile. I will ask you whether that automobile was in your name only.      A. Yes.

Q. Did you use it for any other purpose than for the business of the partnership?



(Testimony of Denton J. Rees.)

A. Yes. As shown here, approximately a little over half of the use of the automobile was going to and from the office.

Q. Over half was going to and from the office?

A. Yes.

Q. The mileage records are kept and you are reimbursed only for the amount expended for business?

A. Yes.

Q. The Director has allowed you \$100, Doctor, for each of these years. That amounts to about 5 per cent of the \$2,100 that was actually expended. Can you operate the automobile for that?

A. No.

[18]

Q. Could you ride taxicabs for \$100?

A. No.

Q. How much is the taxicab fare, Doctor, from Oswego to Portland?

A. Roughly about—round trip would be about \$15.

Q. Now, Doctor, referring to the other exhibits there, Nos. 31, 32 and 33, what do those exhibits indicate?

A. This is the total expense.

Q. Which one is that?

A. This is No. 31, the amount charged to business for the use of the automobile in 1957.

Q. How much was that, Doctor?

A. \$822.50.

Q. Now, look at the exhibit that summarizes the expenses of the partnership, the automobile expenses, for 1957. What exhibit number is that?

A. No. 33.

(Testimony of Denton J. Rees.)

Q. What does that show was actually expended for the use of that automobile?

A. The expenses for the car for 1957 were \$2,095.08.

Q. Out of that the partnership reimbursed you for how much? A. \$822.50.

Q. Now, during the year 1957 the Commissioner again allowed you \$100. Could you have operated any sort of an automobile for \$100? [19]

A. No.

Q. The next item, Doctor, is club dues. I have had handed to you, Doctor, Exhibits Nos. 20, 21, 22, 23 and 24. I will ask you first, Doctor, how do you obtain patients for your practice?

A. The patients are usually obtained through three sources: One, your contact with other men in the profession, dentists and physicians, and their referrals to you. They are obtained from former patients and the general public that you meet, and a source of contacts is through patients whose work you have completed.

Q. During 1956 and '57 were you a member of the Oswego Lake Country Club and the Multnomah Athletic Club? A. Yes.

Q. During 1956 you had made certain charges against or were reimbursed by the partnership for certain expenditures as to the Oswego Lake Country Club. Would you look at Exhibit No. 20 and explain that exhibit.

A. Well, this was the amount that I spent at the Oswego Country Club in the year 1956. The dues

(Testimony of Denton J. Rees.)

were \$252, and other expenses at the club which I charged to business were \$85.55.

Q. Now, were records of any sort kept, Doctor, as to the expenses of the club? For example, what portion were business and what portion were personal?

A. Yes. [20]

Q. How were they segregated?

A. Well, a notation was made if we would have someone to dinner that was a dentist, or invited him out to play golf. Then I made a notation of whatever expense I had in this connection. If it was anything personal, then it was charged to personal expenses.

Q. The amount, then, that is charged to business was that which was traceable, you felt, to business of the partnership; is that right?

A. That is correct.

Q. Did you discuss these clubs generally, or were you already a member of the club when the partnership was formed?

A. I was already a member of the club.

Q. Had you deducted part of this as business expense in the past?

A. I had.

Q. And you continued on the same way?

A. Yes.

Q. Did you discuss this with the partners?

A. Yes, sir.

Q. Did they agree that that was a reasonable expense or that you should join? A. Yes.

Q. Doctor, would you look at Exhibit No. 21. That indicates the Multnomah Athletic Club. What does that exhibit indicate? [21]



(Testimony of Denton J. Rees.)

A. This is my total expenses at the Multnomah Athletic Club for 1956, and the portion that was charged to business and the portion that was personal.

Q. That is similar to Exhibit No. 20; is that right? A. Yes.

Q. Now, look at Exhibit No. 22. What does that indicate, Doctor?

A. This is dues and expenses of the Lake Oswego Country Club for the year 1957, with the amount charged to business and the amount charged to personal expense.

Q. And Exhibit No. 23 is for the Multnomah Athletic Club? A. Yes.

Q. In each instance you have charged, to the best of your knowledge, against the business only that portion of the club dues that were associable with the business; is that correct?

A. That is correct.

Q. Doctor, you have Exhibit No. 24. Would you explain that to the Court.

A. We made a survey of references of patients; that is, in other words, from what sources these patients were obtained.

Q. When a patient comes into your office, Doctor, is any record kept?

A. Yes. The first form we make out is a form that gives the reference here, as to who referred them.

Mr. Pedersen: I think I will introduce that into evidence, [22] your Honor.

The Court: Is that marked now, Mr. Pedersen?

Mr. Pedersen: It is not, your Honor.

(Testimony of Denton J. Rees.)

The Court: Do you have any objection to it, Mr. Biggins?

Mr. Biggins: I have none. I would like to see what it is.

Mr. Pedersen: Q. I will let the doctor look at this next one. What is the yellow slip, Doctor?

A. The yellow slip is a type of history, and it has also on the back side the wording "Operations" of the patient.

Q. Is the information from the white slip transferred to the yellow slip?

A. That is correct.

Q. And the yellow slip, then, is a permanent record of the office?

A. The permanent white slip, plus the additional information, is put on the yellow slip. I mean this is a permanent record. This is just one that the patient apparently makes out.

The Court: 41-A is just a temporary record?

A. Yes.

The Court: We will offer those in evidence.

Mr. Biggins: No objection.

The Court: Admitted.

(The white form referred to was thereupon received in evidence as Plaintiffs' Exhibit 41-A.)  
[23]

(The yellow form referred to was received in evidence as Plaintiffs' Exhibit 41-B.)

Mr. Pedersen: Q. Doctor, you have gone through those records in your office. Are those the records

(Testimony of Denton J. Rees.)

that you used to compile this summary that you have in your hand?      A. That is correct.

Q. That is Exhibit No. 24; is that right?

A. That is right.

Q. Now, would you turn the page there, Doctor, and indicate what that exhibit shows there.

A. Well, there is a list of names. There is a number in front of the name, which indicates the year that the patient's treatment was undertaken, '57 or '56. And in this instance—

Q. To the right of each name is another figure.

A. To the right of the patient's name is a number which indicates the financial cost of the treatment of this patient.

Q. That is, the fee that the patient pays you?

A. That is correct.

Q. You have gone through these office records and from what information you have on the records you have been able to tell where that patient came from?

A. Yes.

Q. And that is the basis for the compilation of the summary that is Exhibit No. 24; is that right?

A. Yes. [24]

Q. Based upon that, Doctor, the caption shows how much business you associate as having received from the Multnomah Athletic Club during 1956?

A. \$6,215.

Q. And from the Oswego Country Club?

A. \$10,106.

Q. That is a total of what, Doctor?

A. \$16,321.



(Testimony of Denton J. Rees.)

Q. All right. Now, Doctor, how about for the year 1957?

A. The Oswego Country Club, \$19,720, and the Multnomah Athletic Club \$8,325.

Q. What is the total?

A. Or \$28,045.00.

Q. Do you figure, Doctor, that based upon experience or what actually transpired that those are ordinary and necessary business expenses of the partnership?

A. Yes.

Q. Would you say that was an expenditure that was well spent or ill spent or what?

A. Well, the amount—with the number of patients acquired through these contacts, it certainly was well spent.

Q. I will ask you this: You have been able to identify the actual patients that you received from each one of these clubs? A. Yes.

Q. The contacts there? [25]

A. Yes.

Q. I will ask you, Doctor, whether or not any of the patients shown on Exhibit No. 24 are your private patients?

A. I have no private patients.

Q. The next item, Doctor, is the element of good will.

The Court: This is now Contention No. 2, Mr. Pedersen, where this comes in?

Mr. Pedersen: This is the element of good will, your Honor. That is No. 2, yes.

Q. Doctor, how long have you been practicing dentistry? A. Twenty-five years.

(Testimony of Denton J. Rees.)

Q. When did you commence specializing in orthodontia?      A. 1946.

Q. In 1946. At that time in 1946 were you alone in the practice or were you with someone?

A. No, I went into a preceptorship with Dr. William Dinham.

Q. A preceptorship is sort of an apprenticeship, to sort of learn the trade?

A. That is correct, along with taking other courses.

Q. How long did you practice with Dr. Dinham?

A. In 1950 Dr. Dinham became ill and had to have surgery, and then was not able to return to practice.

Q. At that time where were you practicing with Dr. Dinham here in Portland?

A. We had offices in the Selling Building. Prior to this time [26] I also had an office in Klamath Falls, Oregon, to which I made trips every two weeks.

Q. In other words, you were maintaining two offices at that time?

A. By 1950 I had obtained another man to take over at Klamath Falls, so that I was practicing only in Portland at that time.

Q. Doctor, you practiced then alone after Dr. Dinham left from 1950 to the association with Dr. Butori and Woods in 1954; is that correct?

A. Yes.

Q. What was the status of your practice in those years, Doctor?

A. Well, in the early years probably the largest volume of my practice was in Klamath Falls, but it gradually had increased here until, as I say, about 1950,

(Testimony of Denton J. Rees.)

or a little before that, I had to quit making trips to Klamath Falls because of the volume of practice here, when I was able to obtain a man to go there. There had been a gradual increase in volume. Then after Dr. Dinham quit practicing there was a certain amount of the element of good will in the association with him, although we each conducted our own separate practices, so that my volume increased very rapidly up until 1954 or '55.

Q. What was the state of your health, Doctor, during that time?

A. Well, one of the reasons I—of course, I liked orthodontia and wanted to go into it, but I had been to Bataan, through [27] the Bataan Death March and a prisoner of the Japanese for three years, and I had a variety of diseases there. When I returned to the practice I became quite tired in the course of general practice, and that was one reason I wanted to go into orthodontia. So I thought it would give me better control of my time and be less physical strain on myself.

Q. What was the state of your practice in 1954?

A. Well, it had reached a point where I just couldn't handle any more influx of patients. There was a great demand for my services, and I had reached a point where I had to either obtain some help or just quit taking new patients.

Q. Doctor, when you talk about patients, did you at that time have patients signed up that had seen you or are you talking about patients that were waiting for treatment?



(Testimony of Denton J. Rees.)

A. The way I have always operated is that nobody is signed up until you actually begin to work on them. There are a large number of people that will come in for an examination, and often they are at the age where there are several years before they are ready to be treated. So you may watch them over a period of time, and they are potential patients. However, they are under no financial or any other compulsion to come to you for treatment when they are ready.

Q. That white card that you explained here, is that similar to what you are doing presently?

A. That is the type of thing that you do on just an [28] examination.

Q. Doctor, if you couldn't handle your patient load, why didn't you hire an orthodontist?

A. Well, there were very few men that had the necessary training—in fact, in this area at that time there were none that were not in practice, unless I could obtain one from the school, and then by the time they had gone through this training, with the demand for service, most of them were not willing to go to work for a salary unless it was on a very temporary basis.

Q. So there were not just any available from the standpoint of hiring someone?

A. That would leave me worse off then ever, if they would come to work for a salary and then quit, because of the additional work, the cases that they started that I would have to finish.

Q. After an orthodontist is out of school and starts taking patients how long is it before he has finished with patients so that he can show the results?

(Testimony of Denton J. Rees.)

A. It is a year and a half to two years before he has completed any patients.

Q. In 1954, March of 1954, did Dr. Butori consult you about a partnership, or did you consult him?

A. He consulted me. He knew that I was trying to work out some situation where I could find a man to possibly go into practice with me.

Q. Now, Doctor, had Dr. Woods and Dr. Butori gone through [29] this trial period so far as proving themselves as far as patients were concerned?

A. Dr. Woods had been in practice for three or four years, and he had been head of the department at the University of Oregon Dental School, so he was fairly well established as far as his reputation was concerned.

Q. Were either one of these doctors willing to go with you on a salary basis? A. No.

Q. What type of partnership, if any, were they willing to enter into?

A. Well, they wanted to enter into a complete partnership, and I preferred that myself.

Q. Doctor, handing you Exhibit No. 3, would you explain briefly what that indicates.

A. Well, this was an agreement of sale that was drawn up between Dr. Woods, Dr. Butori and myself, in which they agreed to buy good will.

Q. Did you specify the amount that was allocable to good will and the amount that was allocable to the assets they were purchasing? A. Yes.

Q. Doctor, what was the intent or what was the agreement so far as accounts receivable and cash on

(Testimony of Denton J. Rees.)

hand and work in progress at the time of this agreement? What was that? [30]

A. The agreement stipulated that all work that had been completed or done on any patients prior to the date of the partnership, the proceeds from that was to be considered the income of the orthodontist that had done the work.

Q. Records were kept as you progressed along in the partnership excluding that part which had been done—

A. That is correct. In fact, some of those accounts—in fact, it was just this last year where they finally entirely paid.

Q. Doctor, in joining forces with two other orthodontists, what type of orthodontia did you hope to practice?

A. Well, I had become very aware of the fact that in building up a practice I had arrived at a point that I couldn't seem to get an answer to what to do when you get to the point where the quality of your work, your health and your time off is being compromised by the fact that you just can't take care of the demand for your services. I thought this might be the solution, in having two other men enter the practice, in which we could set up an arrangement of this clinic nature and employ more auxiliary help.

Q. To your knowledge, Doctor, had the clinic approach to orthodontia ever been attempted before?

A. Not that I knew of.

Q. Dr. Butori, one of the partners, wrote a treatise on that subject, did he not? [31]

A. He has.



(Testimony of Denton J. Rees.)

Q. Now, there were some risks involved in this partnership, Doctor. What were they?

A. Well, one, the ability of the partners to get along mutually. One thing we had to have was a sufficient flow of patients to initiate this type of an arrangement. I mean where we could have enough auxiliary help and a big enough office space—I mean it was necessary to have enough patients to make it feasible, and in a central location.

Q. You didn't have enough patients, Doctor, at that time so that three of you could have just worked on the patients you had, with what they had, to make this work, did you?      A. No.

Q. What did you have to offer in the way of good will, did you believe?

A. Well, I felt that over the years I had practiced here I certainly had completed enough cases in the community that I had good will from previous patients, from the other dentists whose patients I had worked on, and through my contacts and work in the Dental Society and the State Dental Society.

Q. What societies did you belong to at that time, Doctor?

A. Well, I was a Fellow of the American College of Dentists, the International College of Dentists, the American Association of Orthodontists, the Pacific Coast Society of Orthodontists, the President of the Northwest combination of the American [32] Association of Orthodontists and the Anglo Society of Orthodontists.

(Testimony of Denton J. Rees.)

Q. Doctor, what other orthodontists in this city belong to the National Board of Orthodontia?

A. At that time there were—

Mr. Biggins: Excuse me. I believe you mean the American Board.

Mr. Pedersen: The American Board. I am sorry.

A. Dr. Noyes was Dean of the Dental School, and Dr. Dinham, with whom I practiced, was the only other member.

Q. The only other in the whole Portland area?

A. That was in the State of Oregon.

Q. Doctor, what had been the result of this—what you had to offer, you felt, was your reputation within this community. You didn't have patients that were actually signed up in the sense of ready to go to work on, but you had a number of patients, as I get it, that had come to see you and had signed these white slips and were waiting for treatment. Is that it?

A. Well, it was obvious from the increase in my practice over the preceding four or five years, and with the expectation that if the public is aware of what you are doing that this trend would continue, I would probably be able to draw enough patients into the office to make this thing function. As a matter of fact, I had more demand for my services at that time than I could—in other words, I would have had to turn people [33] away. I couldn't take them.

Q. Would your health have allowed you to continue, Doctor?

A. Not at the pace I was trying to go on my own in 1954. That was why I had to do something.

(Testimony of Denton J. Rees.)

Q. In 1954 was it possible for you to take a vacation? How long had it been since you had taken a vacation?

A. I had had one week's vacation since I had gone into orthodontics that was not connected with a meeting or a course or something—

Q. Doctor, financially what has been the situation of this clinic approach to orthodontia? Have you made more or less money than you made before?

A. Actually we have made more. I think that our gross income for the three of us as individuals has been a little greater than mine alone was in 1954, and that was a peak at which I could not have continued to work.

Q. In other words, you have more free time now; is that correct?

A. We have greatly added efficiency by the use of proper office facilities, auxiliary help, and we are able to handle more patients at no more expense and with greater efficiency.

Q. Would you say, Doctor, then, that you have transferred any income to these incoming doctors?

A. I don't feel that—the work was there to do and it had to be done, and I couldn't do it. [34]

Q. How about the incoming doctors so far as their abilities were concerned? Were they of equal ability to you?

A. They each had received their Master's degree from two of the finest graduate schools in the United States in orthodontia.

Q. Doctor, did you intend to sell good will?

A. I did.



(Testimony of Denton J. Rees.)

Q. And to the best of your knowledge the purchasing doctors intended to buy good will; is that right?

A. They did.

Q. Did you bargain for that good will, Doctor?

A. Yes.

Q. And have they paid you for that good will?

A. Yes.

Q. And you did reflect that on your tax returns?

A. Yes.

Q. Now, Doctor, the Government has charged that this was not good will but a re-allocation of income, and as a result they have returned to Dr. Butori and Dr. Woods several thousands of dollars for having overpaid their taxes during these years. To your knowledge are those doctors still contending that they were purchasing good will?

Mr. Biggins: I must object to that, your Honor. I think we have given them quite a latitude here. What these other doctors—

The Court: I think the form of the question is objectionable, [35] but you may answer the question. I will pass on it finally.

A. They did.

Mr. Pedersen: Q. All right. Was the figure of \$35,000, Doctor, to compensate you for your experience over and above the experience of the incoming doctors?

A. I wouldn't say it was experience. They were competent and well trained. It was to compensate me for the additional patients which I would be able to bring to the group through my sources of reference.

(Testimony of Denton J. Rees.)

Q. Again, not the ones you had signed up but the ones that were potential patients?

A. The ones I would be able to bring in.

Q. Would you say that the \$35,000, Doctor, was to compensate you for a larger share of the profits?

A. No.

Q. Doctor, summing this up at this point, at the time that you entered into this agreement you felt that you had a potential not signed up that you could get into this clinic approach; is that correct?

A. Yes.

Q. How about your office location at that time? Where were you located?

A. At the same location, the Selling Building.

Q. Would that type of location be necessary?

A. It would with a practice of this type. A one-man practice [36] would probably work well in a suburban location, where you are drawing from the immediate area. But when you try to get into a larger group, where you are working with a greater flow of patients, then you must be pretty centrally located, because our patients come from all directions. We have patients coming from Alaska and from—

Q. Where did Dr. Butori and Woods have their offices at that time?

A. They were located on the East Side, in the Hollywood District.

Q. Do you feel that you could have maintained this group over there in that area?

A. I don't believe it would have been feasible or worked, because of such a large number of patients

(Testimony of Denton J. Rees.)

that came from the West Side of Portland, came from Oswego—that area would be very inconvenient for them.

Q. Now, in 1954 what was the situation so far as rental space was concerned?

A. It was very difficult to obtain.

Q. Now, Doctor, was there a question as to whether these patients, with the personal relationship that you had built up in their treatment, would allow another doctor to work on them?

A. There was this question. Of course, it had to be discussed with each patient.

Q. After this partnership was formed did you go over the [37] records of each patient?

A. We went over together the records of each patient, in their practice and my practice, and we introduced each patient to the other doctors, explained what we were doing, and tried to inform each other of the progress of the work in each case.

Q. What percentage of the patients, if you know, objected to being treated by one of the other doctors?

A. Well, there were probably, I would say, maybe three or four per cent that wanted the doctor that had started to continue the work.

Q. Doctor, the clinic approach to orthodontia, to your knowledge, being first in the United States, what has it done for the cost of services, for example?

A. Well, again, I wouldn't say that there had not been other clinic approaches to it, but I think this was the first of its type—that is, where maybe one or two older men have tried to use younger men on salary, with sort of an overflow and men coming in and out. But



(Testimony of Denton J. Rees.)

where we have tried to operate as an equal partnership in a group, this is the first of its type, and I think it has had a great deal to do with keeping fees at a lower rate in the Portland area than they are elsewhere on the Pacific Coast.

Q. Doctor, would you consider orthodontia a practice so specialized that these patients were coming to you because of a special technique that you had learned to do, or something? [38]

A. No. As I say, there are no secret techniques or mysteries. That is why we all give courses, give papers, to acquaint the other men with what we know. There are differences in techniques, but probably as of today most of the major graduate schools, and about 65 or 70 per cent of the orthodontists in the United States, are using almost the identical technique that we do. I mean there is just little individual variations, but the general technique is that used by—

Q. So you really, Doctor, had the potential to bring patients in; is that right?

A. That is correct.

Q. Doctor, do you have one of those exhibits there that is a bill of sale—the small one?

The Court: What is the number?

Mr. Biggins: Exhibit 38, I believe, Dr. Rees.

The Witness: It is No. 37.

Mr. Pedersen: That is a bill of sale, is it not, that you gave to the purchasing doctors?

A. This is a bill of sale.

The Court: It is not marked 37 in the pre-trial order.

(Testimony of Denton J. Rees.)

Mr. Biggins: If the Court please, we will straighten out the exhibit numbers during the recess and make a correction, if necessary, for the record.

Mr. Pedersen: That is perfectly all right.

The Court: There is a bill of sale that is known as [39] Exhibit 38 in the record. Go ahead with your questioning.

Mr. Pedersen: Q. What does that represent, Doctor?

A. This is the bill of sale for a two-thirds interest in the equipment and supplies of the office I had in the Selling Building.

Q. Was that in connection with this agreement of sale which we have been discussing? A. Yes.

Q. Doctor, what number is that partnership agreement? What exhibit number is that partnership agreement there? Is that No. 3?

A. The agreement of partnership is No. 4. The agreement of sale is No. 3.

Q. All right. Then No. 3 is the agreement that you entered into with Drs. Butori and Woods; is that correct? A. Yes.

Q. How were you to divide the profits and losses under that partnership?

A. They were to be divided equally.

Q. I don't know whether I asked you this, but I will ask you whether the doctors were willing to go in on any other arrangement but an equal arrangement?

A. No.

Q. Looking at the agreement amending the partnership there, have you recognized good will in the partnership? [40] A. Yes.

(Testimony of Denton J. Rees.)

Mr. Pedersen: I have no further questions of Dr. Rees.

(Short Recess.)

Cross-Examination

By Mr. Biggins:

Mr. Biggins: May it please the Court, from an independent examination and investigation that I have made of the expenses involved—and may I call it the expense issue in this case—and from the testimony of Dr. Rees under oath this morning, the Government is prepared to stipulate that the automobile expense claimed by Dr. Rees during 1955, '56 and '57—is that correct?

Mr. Pedersen: That is right.

Mr. Biggins:—is correct as claimed.

Q. As I understand it, Doctor, the amount claimed by you is very carefully segregated as to personal and business use, is that correct, sir?

A. That is correct.

Q. And the amount claimed by you and reimbursed by the partnership did not, sir, include any travel from your personal residence to your place of business and back again, no commuting expense, sir?

A. No, sir.

Q. Only in your judgment professional and business expenses [41] have been claimed on a mileage basis? A. Yes.

Mr. Biggins: All right. The Government is prepared to make that stipulation. You accept it, of course, Mr. Pedersen?

Mr. Pedersen: Yes, we accept it.



(Testimony of Denton J. Rees.)

Mr. Biggins: On the trip to Hawaii, your Honor, the Government is prepared to stipulate that the amount as claimed is proper and is an ordinary and necessary expense deduction if the amount of air transportation of Dr. Rees over there is reduced by 50 per cent to make some allowance for personal pleasure.

Q. You were there 30 days as a vacation, Doctor?

A. Yes.

Mr. Biggins: And, further, to adjust the cab fares and limousines to 50 per cent. We make no contest of the remaining balance if they are prepared to adjust the air transportation and cab fare by 50 per cent.

The Court: Do you have anything to say on that, Mr. Pedersen?

Mr. Pedersen: We accept that. Do you accept that, Dr. Rees? A. Yes.

Mr. Biggins: On the telephone expense, your Honor, the Government is prepared to stipulate that the amount as claimed is properly allowable as a business deduction. [42]

Q. So my record on this will be clear, Dr. Rees, as I understand it, you do make personal use of that phone, do you not? A. Yes.

Q. And it also would have been possible and perhaps even preferable to have put a business telephone in your residence under a separate number; is that correct? A. Yes.

Q. If you had put in a business telephone the cost would have been more? A. Yes.

Q. That is, more than the amount you have claimed here? A. Yes, it would.

(Testimony of Denton J. Rees.)

Mr. Biggins: On that testimony, your Honor, we stipulate that the amount claimed by the doctor is proper as an ordinary business expense deduction.

On the residence there is no dispute. We have checked and found out, your Honor, the doctor does make use of this office in his home. We believe the average is about ten patients a month, is it not, Doctor? A. Yes, sir.

Q. However, it is not used during the day, but only after office hours? A. Correct.

Mr. Biggins: We are prepared to stipulate for these years, your Honor, if we may refer to Exhibit 8 for precision, that the [43] amount of depreciation as claimed there is correct and is allowable, \$616.08; that the amount of electricity and maintenance would be correct if we apply a ratio of 10 per cent, which would make for 1958, which is Exhibit 8, electricity \$21.33 and heat \$20.62.

Mr. Pedersen: You said 1958.

Mr. Biggins: Exhibit 8 for the year 1955, so I may correct the record. That depreciation in the amount of \$616.08, electricity in the amount of \$21.33, and heat in the amount of \$20.62 are proper and allowable as ordinary and necessary expense deductions. We offer that as a stipulation.

Mr. Pedersen: Do you accept that, Doctor?

A. Yes.

Mr. Biggins: Q. So there will be no misunderstanding, Doctor, that leaves out the maintenance as claimed in that year. A. Yes.

Mr. Biggins: All right. Now, on Exhibit 12, as a

(Testimony of Denton J. Rees.)

point of reference, the Government offers to stipulate that the amount of depreciation as there claimed, \$616,-08, is proper and allowable, along with electricity in the amount of \$20.79 and heat in the amount of \$25.36, and this sum at the bottom is allowable as an ordinary and necessary business expense deduction. We offer that as a stipulation.

Mr. Pedersen: Do you accept that, Doctor?

A. Yes. [44]

Mr. Biggins: Q. You understand, Doctor, that reduces the amount of electricity and heat to 10 per cent and disallows the water? A. Yes.

Mr. Biggins: All right, sir. Now, on Exhibit 14 the Government offers to stipulate that the amount of depreciation claimed there—that was the last part of the five-year period, wasn't it, Doctor?

A. I believe that is true.

Mr. Biggins: So it is only \$308.02? A. Yes.

Mr. Biggins: And we do not disallow any of the amount claimed there. We concede that as proper, along with electricity in the amount of \$21.61 and heat in the amount of \$21.05, again disallowing the water, Doctor. We offer that as a stipulation.

Mr. Pedersen: Is that acceptable, Doctor?

A. Yes.

Mr. Biggins: I believe the last expense, Dr. Rees, is the amount of club dues in the Multnomah Athletic Club and the Oswego Lake Country Club. That is our last expense item, is it not? A. Yes.

Mr. Biggins: The Government offers to stipulate, your Honor, that, for instance, on Exhibit 23, if we



(Testimony of Denton J. Rees.)

may use that as a frame of reference—there are Exhibits 20, 21, 22 and 23, if [45] I may approach the witness—

The Court: Yes.

Mr. Biggins: —so I may check my numbers. Showing you, Dr. Rees, the club dues and expenses for 1956, which is identified as Exhibit 20—will you examine that, please. A. Yes.

Q. You see to the far right on that schedule it says “Business,” with a subtotal of \$85.55. You do see that column? A. Yes.

Q. Next to that column you see a column identified as “Personal”? A. Yes.

Q. Which on Exhibit 20 totals \$8.05?

A. Yes.

Q. Which is similar on Exhibit 21? You see that, sir? A. Yes.

Q. And similar on Exhibit 22? A. Yes.

Q. And similar on Exhibit 23? A. Yes.

Q. Now, where you have in that last column marked “Business,” that is in your judgment—

The Court: The last column?

Mr. Biggins: The next to the last column, your Honor.

Q. You do see the next to the last column marked “Business”? A. Yes. [46]

Q. Those expenditures there represent, in your judgment, business contacts and business expenditures?

A. Yes.

Q. As distinguished from the next column marked “Personal”? A. Yes.

(Testimony of Denton J. Rees.)

Q. Which you admit and do not contest represent personal expenditures?      A. Yes.

Mr. Biggins: The Government offers to stipulate, your Honor, that if we take a proportion of the column marked "Business" with the column marked "Personal" and apply that to the club dues and membership paid, that that proportion that comes out as applied to business is a proper deduction as an ordinary and necessary business expense deduction.

Mr. Pedersen: As I understand that, now, Mr. Biggins, you mean that in that column on Exhibit 20 that would be roughly 10 per cent; is that correct?

Mr. Biggins: I would add the \$85.55, Mr. Pedersen, under "Business" to the \$8.05 under "Personal," and the total would be \$93.60.

Mr. Pedersen: Yes.

Mr. Biggins: Then for "Personal" I would divide the \$93.60 into \$8.05 and get a percentage and apply that percentage to \$252 and disallow that amount as an ordinary and necessary business expense deduction.  
[47]

Mr. Pedersen: All right.

Mr. Biggins: Otherwise stated, I divide the \$93.60 into \$85.55 and apply that to the \$252 on Exhibit 20 and allow that amount, which of course is reciprocal and the complement to the other percentage.

We offer that as a stipulation on Exhibits 20, 21, 22 and 23.

Mr. Pedersen: Your Honor, I would have to discuss that, because if we follow that theory out—I notice here on Exhibit 23 we would get no credit, or very little credit, for business in that year.

(Testimony of Denton J. Rees.)

The Court: You have offered that stipulation and it has not been accepted, as I understand it.

Mr. Pedersen: We can't accept that one.

Mr. Biggins: May I say for the record that I had understood this was a package situation. Nevertheless, since the package has not been accepted, the Government will stand by the prior stipulations.

Q. To cross-examine you, then, Doctor, on these personal expenditures, would you examine Exhibit 23 which has been invited to your attention, sir. If you will, sir, will you have before you also Exhibits 20, 21 and 22.

In the last column, marked "Personal," Dr. Rees, the total there, as you see it, is \$270.75. Is that correct?

A. Yes. [48]

Q. That amount represents your own judgment as to what represented personal expenditures at the Multnomah Athletic Club during the year 1957?

A. Yes.

Q. And the column next to that on the inside, marked "Business," totals \$57.30; is that correct, sir?

A. That is correct.

Q. And, again, that represents your own judgment, Dr. Rees, as to what was a proper business expenditure at that club during that year? A. Right.

Q. Now it is true, Dr. Rees—do you see the column over there marked "Dues?" A. Yes.

Q. —which totals \$202.20? Do you see that?

A. Yes.

Q. You do claim that total amount of dues paid as a business expenditure, do you not, sir?

A. Yes, sir.



(Testimony of Denton J. Rees.)

Q. Even though in this year you used this club much, much more for personal use than you did business use, did you not, Dr. Rees?

A. As far as added expenses, the situation being that if I went to the club or my expenses were of a personal nature I still made contacts. To my way of thinking, this meant that [49] this money that was expended at the club was for my or my family's expenses, but did not preclude the fact that while I was there I was in contact with people that were or would be potential patients.

Q. You understand, of course, Doctor, that I am not suggesting and haven't, in your view, that you didn't use the club for business purposes? You do understand that, sir?

A. Yes.

Q. But your wife did use the Multnomah Athletic Club, did she not?

A. Yes.

Q. And she used the Oswego Lake Country Club as well?

A. Very minorly.

Q. But she did?

A. She did, yes.

Q. And for social purposes? For social purposes?

A. Some. Not very much.

Q. When she went out there it was for social purposes usually, wasn't it, Doctor?

A. The point is she wasn't playing golf, and we didn't attend too many of the real social functions.

Q. But you did attend some, sir?

A. Yes.

Q. When you attended social functions, those were segregated out as personal expenditures, weren't they?

[50] A. Correct.

Q. As you did in all of these expenses?

A. Yes.

(Testimony of Denton J. Rees.)

Q. So you did use these clubs in part for social activities? A. Yes.

Q. In the proportions as indicated on Schedules 20, 21, 22 and 23? A. Yes.

Q. That is all on that series of questions, Dr. Rees. Now, about the good will. How long did you say that Dr. Butori had been practicing at the time you entered into the partnership agreement, which I believe is Exhibit 4, sir?

A. He had been in the exclusive practice of orthodontics approximately a year. He had been in the practice of dentistry.

Q. How long at that time had you been in the practice of orthodontics, Doctor?

A. Let's see. From '46 to '55. That would be approximately eight years at the time.

Q. You were at that time a member of the American Board of Orthodontists? A. Yes.

Q. Was Dr. Butori? A. No.

Q. You mentioned, I believe, that you were adopting in this new partnership the clinic approach. Was that the descriptive [51] phrase that you used?

A. Yes.

Q. Before this time Dr. Woods and Dr. Butori had been practicing their profession together as partners?

A. Yes.

Q. At another location? A. Yes.

Q. And you yourself, sir, had been practicing by yourself? A. Yes.

Q. And after the partnership was formed what was that group then known as?

(Testimony of Denton J. Rees.)

A. I believe the Portland Orthodontic Clinic.

Q. Which you later changed, of course, to—

A. Group.

Q. Because—

A. —of the implication that the word “Clinic” suggested a free or public place of business. At least, it was so considered in dentistry.

Q. In the practice of dentistry it was professionally more becoming to change “Clinic” to the name “Group?”

A. Yes.

Q. And announcements were sent out, weren't they, when the new partnership—may I call it the new partnership? Do you know what I mean by that?

A. Yes. [52]

Q. Announcements were sent out?

A. I believe we did at that time. However, it was about a year later that we obtained our new quarters and announced that.

Q. But the announcement mentioned the several doctors' names, Dr. Wood, Dr. Butori and yourself, did it not?

A. I believe this was done about a year later.

Q. But the group was referred to and you yourself referred to this group as the Portland Orthodontic Clinic at that time?

A. That is correct.

Q. And it was the discussion of the clinic approach that led to the adoption and formation of this new partnership?

A. That is correct.

Q. Would you explain the background and the discussions that took place that led up to this decision, the clinical approach, sir.



(Testimony of Denton J. Rees.)

A. Through my prior experience in working with Dr. Dinham, and particularly in view of what happened in his case, where a man became suddenly ill and was forced to suspend his practice, the welfare of patients is left entirely in the air. There is no means that the patient or the parent has to continue this work unless some other person is willing to step in and take over. This leads to a great number of complications as to the amount of the fee that has been paid, as to the amount of work that has been done, and often it leads to quite a bit of litigation. Where you have the welfare of these children in your [53] hands it is quite a concern to you that you feel that illness or accident might jeopardize the service to them. There is also the fact that I feel that in any line of work that is this concentrated it is necessary to occasionally have a vacation and get away. It is necessary to be able to attend professional meetings. Where you have a group of men this can be more easily arranged, when the other men are present to take care of the patients. We find that now one or more of us can attend all national meetings and keep up with all the advances, where it is not possible for one man to do that.

The matter of the patient load we felt could be much better handled. At that particular time I was in a position where I could not begin to answer the demands on my services. With the other two men, and through the operation of the clinic and a more efficient procedure, we felt that we could accomplish more, and we could do it with no increase in cost and provide a better service.

(Testimony of Denton J. Rees.)

Q. In a word, Dr. Rees, the clinic approach is quite a different approach from the individual professional practitioner approach, is it not? A. It is.

Q. And in the clinic approach the clients—we do refer to them as clients, do we not?

A. Or patients.

Q. Or patients. Excuse me. The patients come to the group [54] and not to a particular doctor?

A. Once the group has become established that is true.

Q. I believe you stated that no more than 4 per cent objected to this change in policy.

A. Those were the patients who were already under treatment, who I or Dr. Woods or Butori had accepted as individual patients.

Q. And I believe you said because of the clinical approach you needed a central downtown location?

A. Yes, sir.

Q. Which is not necessarily true of the individual practitioner? A. No.

Q. As Dr. Butori and Dr. Woods had been before?

A. That is

Q. And you and your former associate?

A. Yes.

Q. And when you were practicing by yourself?

A. That is true.

Q. Now, your membership in the American Board of Orthodontics is personal to you and not transferable; isn't that true? A. That is true.

Q. And your memberships in these many professional societies which you mentioned, sir, are personal

(Testimony of Denton J. Rees.)

to you and non-transferable? A. That is true.

Q. The practice of the profession of orthodontics, like the practice of law and dentistry, does not permit advertising for [55] patients, does it? A. True.

Q. You do not advertise and have not advertised?

A. No.

Q. You may not transfer your license to practice orthodontics or dentistry, may you, Doctor?

A. No.

Q. Any more than an attorney may?

A. That is right.

Q. Now, as to the extent of your physical assets that you sold under what has been marked, I believe for identification, as No. 38, the total was \$40,000, I believe you stated, Doctor. A. Yes, sir.

Q. And of that total of \$40,000 I believe \$5,000 only was on the physical assets of the office itself?

A. Yes.

Q. Did the other doctors bring in physical assets as well? A. Yes.

Q. And did they receive credit for that? Why were you just paid for your physical assets and they were not?

A. Because the physical assets I had were, we felt, that much in excess of the amount that they had.

Q. Both groups had physical assets, I take it, Doctor? A. Yes.

Q. But yours exceeded theirs in value by approximately \$5,000? [56] A. Yes.

Q. And you listed them in detail on Exhibit 3, did



(Testimony of Denton J. Rees.)

you not, as to what they represented, and it totals up—that is the last page of Exhibit 3, Doctor.

A. I don't have that.

Mr. Biggins: If I may approach the witness, your Honor, perhaps I could indicate rather rapidly.

The Court: Yes.

A. Yes, I have it here.

Q. It is the last page, is it not, which itemizes some assets in detail. So I may read it in the record, Doctor, it represents three dental chairs, \$2,250, and various other equipment? A. Yes.

Q. After the clinic was formed how many dental chairs did you have at the clinic, Dr. Rees? More than three? A. Yes. Five.

Q. Those additional two, did Dr. Woods or Dr. Butori bring those over or did you purchase new ones?

A. I believe one of them was brought over.

Q. And one was purchased new, then?

A. Yes.

Q. In the practice of orthodontics how important is the relative cost of the physical equipment itself as compared to what you have referred to as the good will and professional reputation of the practitioner?

[57]

A. Well, I would say rather small in comparison.

Q. This amount, I believe, was computed at approximately \$40,000, wasn't it, Dr. Rees?

A. Yes.

Q. How did we arrive at that exact amount?

A. Well, it was arrived at by somewhat considering the earning capacity of each of us as individuals

(Testimony of Denton J. Rees.)

over prior years or preceding years, the potential that each of us had for bringing into the group as it was organized new patients, which in turn meant additional income, and our individual sources of references and the potential we had through patients and professional people for drawing patients to the group.

Q. In summing this, Dr. Rees, you did actually make an arithmetical computation; that is true, isn't it?

A. This was arrived at by a discussion and, you might say, dickering.

Q. Your gross income at that time was approximately \$80,000 a year, Doctor? A. Yes.

Q. And you discussed that?

A. For the one year. That is, for 1954.

Q. Yes, sir. Approximately \$80,000?

A. Yes.

Q. And that amount was discussed with Dr. Woods and Dr. Butori? A. Yes. [58]

Q. And their gross amount at that time was approximately \$40,000?

A. Yes.

Q. And you discussed that with the two doctors?

A. Yes.

Q. The difference is approximately \$40,000?

A. Yes.

Q. And it was that difference between these two amounts of gross income that you arrived at in determining the amount of what is called good will here in this instrument?

A. It acted as one factor in the discussions, yes.

(Testimony of Denton J. Rees.)

Q. It was the big factor, as you so told us; isn't that true?

A. Well, not necessarily. The amount of money—

Q. By the way, was Dr. Woods there? Where was Dr. Woods when this instrument was executed?

A. He was here at the time. He was in the service part of the time during the Korean War.

Q. At the time this instrument was executed was he practicing orthodontics full time? A. No.

Q. How long after the instrument was signed before he was practicing full time?

A. One year.

Q. So the first year that we have here Dr. Woods did not work full time in the clinic at all, did he? [59]

A. No. He was back on several occasions—I mean he worked with us, but he was at Bremerton part of this time, so that he was here on week ends and occasionally. But he didn't work full time, no.

Q. Nevertheless, he did share in one-third of the profits? He did share equally in the profits?

Q. At the time you discussed setting up the clinic

A. Yes, sir.

approach you knew that Dr. Woods would not be there for at least one year?

A. Yes, sir.

Q. And that was one of the discussions you had in arriving at this so-called amount of good will, was it not?

A. Yes. Of course, his prior agreement had been with Dr. Butori, and I had to take into consideration the agreement between the two of them.



(Testimony of Denton J. Rees.)

Q. But your agreement eventually was with the two of them? A. That is right.

Q. To share the profits and losses equally?

A. Yes.

Q. With Dr. Woods? A. Correct.

Q. And Dr. Butori?

A. Yes, sir.

Q. Knowing that Dr. Woods would not be back for active [60] practice for at least one year?

A. Yes.

Q. And this was satisfactory to you after the differential of \$40,000 was agreed upon by the parties?

A. Yes.

Mr. Biggins: That is all.

The Court: Do you have anything more, Mr. Pedersen?

Mr. Pedersen: Yes. I would like to ask the doctor a few questions.

#### Redirect Examination

By Mr. Pedersen:

Q. Doctor, referring to the exhibits there on the clubs, which I think are Exhibits 20, 21, 22 and 23, relating to these clubs, do you have the summary there of the clubs? A. Yes.

The Court: Are these what you are referring to?

Mr. Pedersen: No, sir. There is a summary of the patients.

The Court: A summary of the names of the patients?

Mr. Pedersen: That is correct.

Q. Doctor, is there any relationship, looking at Ex-

(Testimony of Denton J. Rees.)

hibits 21, 22 and 23—you have broken those figures down into elements that are chargeable to business expense and that which is personal?

A. Yes, sir. [61]

Q. Looking at the summary again for the year 1956, I believe you show total business having come out of that club of how much?

A. Oswego Country Club, \$10,106.

Q. And Multnomah Athletic Club?

A. \$6,215.

Q. Would you say, Doctor, that the predominant use of that club, noting now the business that you actually got out of it, was for business purposes?

A. Yes.

Q. When your wife went there, Doctor, what did she use the club for or how much did she use this Oswego Country Club?

A. Relatively little. Once in a while we would have personal guests that we would take to dinner, and I believe she went to a couple of fashion shows. I don't think in the entire time we went to more than one dance.

Q. All right. Now look at the exhibit for 1956. How much dues and how much was paid to the Oswego Country Club, for example, altogether, all told?

A. All told in 1956, \$345.60.

Q. Out of that you got business of \$6,000?

A. Yes.

Q. So far as the Multnomah Athletic Club is concerned, what did you expend there?

A. The total expenditures for 1956 were \$296.13.

[62]

(Testimony of Denton J. Rees.)

Q. And out of that you got how much business?

A. \$6,215.

Q. Would you say the predominant use of that club was for business purposes during the year 1956?

A. Yes.

Q. Doctor, when you entered into the agreement with Dr. Woods and Dr. Butori whose patients were they that were being worked on by the partnership when Dr. Woods was gone?

A. Well, the patients that had priorly been in my practice and those that had been in his practice which Dr. Butori had taken over.

Q. In other words, prior to this partnership Dr. Woods and Dr. Butori were on a profit-sharing agreement?

A. Correct.

Q. Dr. Butori was working primarily—

Mr. Biggins: If the Court please, I have been quite liberal on leading questions.

The Court: It is very leading. Sustained.

Mr. Pedersen: Q. What arrangement had been made between Dr. Woods and Dr. Butori prior to the partnership, do you know?

A. I believe they had—there was a profit-sharing arrangement under which Dr. Butori kept a percentage of the income from the—

Q. Dr. Woods was older in the practice than Dr. Butori; isn't that correct? [63]

A. That is correct.

Q. At the time of entering into this were those patients primarily Dr. Woods' or Dr. Butori's patients?

A. Primarily they were Dr. Woods'. However,



(Testimony of Denton J. Rees.)

in their agreement there would have had to have been some arrangement made at the end of Dr. Woods' service to distribute—either they would have had to have continued the partnership or the patients would have had to have been distributed between them at that time.

Q. In other words, Doctor, after you started the partnership you comingled the patients that you all had; isn't that correct?

A. That is correct.

Q. After the partnership was once commenced you may work on some of the patients that had previously been Dr. Butori's and he may work on some that had previously been yours; is that right?

A. We all worked on all the patients, with very few exceptions—maybe two or three per cent that particularly want one doctor to do it. We give them this choice, but I would say this has been true from the beginning, that probably 95 per cent of the patients we all see and we all work on and we rotate on.

Q. That was part of the negotiations of the agreement, was it?

A. That was one of the principal reasons we went into this, that under those circumstances, if a doctor is gone on vacation or to a meeting, the patient's work is not necessarily held up [64] because he has only seen one doctor and he is not there to take care of them. The other doctors can proceed with the work. For that reason we all go over all records on every patient prior to treatment, outline the treatment that

(Testimony of Denton J. Rees.)

is to be employed, how we are going to attack it, so that we are fully aware of the whole history of the patient.

Q. Counsel mentioned that you made \$80,000 during 1954.

Mr. Pedersen: Excuse me. If I gave that impression, I certainly want to correct it.

The Court: Gross, I think he said.

Mr. Pedersen: Gross.

Q. Doctor, out of that gross how much did you net?

A. I don't have those figures in front of me here, but I would say probably it was about \$45,000.

Q. After this partnership was commenced was your gross larger or smaller than \$45,000?

A. The first year I believe it was a little bit smaller, but succeedingly it has been as large or larger.

Q. Now, considering, Doctor, the time that you had free to go to clinics, the time that you have taken off for vacations and the time that you have been away from your office, have you expended more or less hours for the income that you have earned in subsequent years?

A. Definitely less hours have been expended in the practice, and then I have had these other advantages with no less income; [65] in fact, a slight increase.

Q. In other words, the partnership has been able to function efficiently, wouldn't you say?

A. Yes.

Mr. Pedersen: I have no further questions.

(Testimony of Denton J. Rees.)

Recross-Examination

By Mr. Biggins:

Q. Just a few more, Dr. Rees. Would you be mindful, sir, how you used the word "predominantly" when you were describing the relative business and personal use of the country club? Would you be mindful of that word "predominantly"?

A. Yes.

Q. Now, Dr. Rees, when you went to Hawaii the clinic lasted how many days? One day, sir?

A. Yes.

Q. And after the clinic you visited a few offices in town which took no more than how many days?

A. Oh, a total of four. I spent one day going over some research that was being done on Orientals at the University of Hawaii.

Q. Now, your wife went over with you?

A. Yes.

Q. Your son went over with you?

A. Yes. [66]

Q. Your daughter went over with you?

A. Yes.

Q. You toured the Island, and you were for a while at the beach on the other side? A. Yes.

Q. You stayed there approximately 30 days?

A. Total, yes.

Q. All right. Now as you have used the word "predominantly" a moment ago, Doctor, was that trip from the family point of view predominantly business or predominantly a vacation? I submit, sir, it was predominantly a vacation.



(Testimony of Denton J. Rees.)

A. The time spent there was predominantly a vacation.

Q. All right. Thank you.

A. The reason for going was predominantly for business. I wouldn't have made the trip if I hadn't been going over for this meeting.

Q. But before you left and after you got back you and the other members of your family referred to that as your vacation; is that not true?

A. I did take my month's vacation for the year.

Q. Now, Dr. Rees, how long did you say it took or takes to secure a patient and follow it through the full course of treatment in orthodontics? Was it approximately two years or two and a half, or what did you say?

A. It can vary anywhere—if it is a minor case, you might [67] do it in six months, but many—I would say an average is about a year and a half to two years. Some take three, four or five years.

Q. But an average is a year and a half to how many years?

A. About a year and a half to two years.

Q. At the time the clinic partnership was formed how many years did you say Dr. Butori had been in practice?

A. He had been in practice a year.

Q. In other words, not enough time to take care of an average follow-through on the average patient?

A. However, he had—

Q. Would you answer the question and then explain, Doctor?

(Testimony of Denton J. Rees.)

A. Not if he had started his patients from the beginning, but he didn't.

Q. We understand that. He did take over some patients from Dr. Woods; that is true?

A. Well, he took over all patients from Dr. Woods.

Q. His whole practice? A. Yes.

Q. All right. Now, I believe you stated that the first year after the clinic was formed your net income or your gross income was lower?

A. I believe my gross was slightly lower the first year after the partnership.

Q. After that it picked up again? [68]

A. Yes.

Q. And it was after that that Dr. Woods came back to practice, was it not? A. Yes.

Q. And you didn't have the full benefit of his services during that first year? A. Correct.

Q. And you knew that at the time this instrument was executed? A. That is correct.

Q. That was one of the considerations in arriving at the amount for the differential of good will?

A. No, I don't believe it was a main consideration.

Q. It was a consideration, Doctor? You did agree to share your profits—

A. In the fees. Not the fact that there would be one year that he was in the service of the Government and was therefore unable to be there. I mean over the long picture we all expected we had many years of practice left, and this one year—also, we had to take into consideration the good will arising to some extent from him and the work that he was doing. So I mean the lack of his being there—of course, that cut

(Testimony of Denton J. Rees.)

down the gross of the partnership for one year, but I don't think that the fact he was in the service this one year was a major consideration in the amount of money that was received for good will, no.

Q. I simply was asking this question, Doctor, and let's be done [69] with it: It was a consideration, at least, in the determination of the amount that the parties discussed and concluded should be assigned to good will?

Strike that question, and let's get at it this way: You did at the time you entered this clinic-partnership arrangement intend to and you did expend an equal amount of time with young Dr. Butori, didn't you?

A. Yes.

Q. And you intended to? A. Yes.

Q. He was there pretty much full time and shouldered his share of the load, did he not?

A. Yes, he did.

Q. Although he had substantially less experience than you yourself? A. Yes.

Q. All right.

A. He had less experience.

Q. Dr. Woods the first year, at least, did not shoulder that burden, did he? A. No.

Q. And you knew at that time that he would be unable to because he was in the armed forces?

A. That is correct.

Q. And that was a consideration in arriving at the amounts [70] used in the final agreement that was signed?

A. I don't believe it was ever discussed in that light



(Testimony of Denton J. Rees.)

or what this would cost for him being in the service for a year.

Q. But you knew he wouldn't be there that first year? We have established that. A. Yes.

Q. And that was a consideration? Surely we must admit that, Dr. Rees? That was a consideration, now, wasn't it?

A. Had this not been formed he would have still received income under the prior agreement from Dr. Butori.

Q. And that was a consideration?

A. But—

Q. Can we get a direct answer? If you are unable to give it—

A. It is a difficult thing to answer directly, because I don't believe that I did assess the value of or what it would cost for him being in the armed forces for that year.

Q. But you did try to assess the value of other things?

A. We were primarily trying to assess the value of the patients, what the future would be to the group of patients that we were able to bring into the office.

Q. By the group you mean the clinic?

A. The clinic, yes.

Mr. Biggins: That is all. [71]

#### Redirect Examination

By Mr. Pedersen:

Q. May I just ask a couple of questions, Doctor. What was the situation so far as orthodontists were concerned when you entered into this agreement?

(Testimony of Denton J. Rees.)

A. Well, at that time the only schools that were on the West Coast—the University of Washington just started about a year or two prior to that, and I think that year, during the Korean War, they were only taking about five men a year. However, now they graduate ten a year. The University of California turns out five men a year. The University of Southern California has sometimes had a school, but it has also—during these years I doubt if they were turning any men out. There was about maybe 15 or 20 orthodontists being educated and entering into the practice on the West Coast.

Q. In short, Doctor, there were no available orthodontists in Portland; is that correct?

A. That is correct.

Q. That is, new ones. And out of all of the orthodontists that were available, how about Dr. Woods so far as his experience and his education was concerned? How did he compare with the others?

A. Well, I think comparatively he had about as fine a background and experience as you could ask for.

Q. When counsel for the Government keeps talking about the [72] experience when an orthodontist gets out of school, what is the extent of his experience? Can he go right to work? A. Yes.

Q. When you talk about experience in the field of orthodontia, you are not talking about an orthodontist that has to go out and spend a number of years to get adept at his profession?

A. He has had—in addition to all the dental background he has had in his dental degree, then he has had two years of graduate work in this specialty field.

(Testimony of Denton J. Rees.)

It may be that in some cases a man may be a little bit slower than a man with more experience. In other cases some of them have a great deal of speed right to begin with.

Q. Now, so far as Dr. Butori was concerned, he had been working on patients that may have had two months or three months to complete, or even five months. So during the year that Dr. Butori was working had he finished results?

A. Oh, yes, he had completed—

Q. In other words, he didn't start cold like an orthodontist would that went out of school and started to practice; isn't that right?

A. No.

Mr. Pedersen: No further questions.

Mr. Biggins: Thank you, Dr. Rees. That is all.

(Witness excused.) [73]

GUY WOODS, JR.,

was produced as a witness in behalf of the Plaintiff and, having been first duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Pedersen:

Q. What is your profession, Doctor?

A. I am an orthodontist.

Q. When did you graduate from dental school?

A. 1945.

Q. When did you take your study in orthodontia?

A. 1947 and 1948.

Q. And you immediately practiced orthodontia after graduating, did you?

A. Yes.



(Testimony of Guy Woods, Jr.)

Q. What school did you graduate from?

A. In orthodontics?

Q. Yes. A. University of Illinois.

Q. Were you practicing orthodontia here in Portland after 1948? A. Yes.

Q. Were you practicing full time?

A. No. I was practicing in—I was at the University of Oregon Dental School in the Orthodontic Department. I was practicing, but part private and part at the Dental School. [74]

Q. I see. Did you enter into a partnership with Dr. Butori, Dr. Woods? A. Yes.

Q. When did you enter into the partnership?

A. With Dr. Butori?

Q. Strike that question. Did you ever enter into a profit-sharing agreement—let's put it that way—with Dr. Butori? A. Yes, I did.

Q. What occasioned you to enter into that agreement with Dr. Butori?

Mr. Biggins: You are examining what is marked for identification as Exhibit 1. Isn't that true, Doctor?

The Court: Is that Exhibit No. 1?

A. Yes. Because I was recalled into the Navy.

Mr. Pedersen: Q. Had the Government furnished part of your cost of education?

A. Well, during World War II I was in Dental School, but I was in what they called V-12, the Navy program, and at the completion of that I went into the Navy as a dental officer, and after a period of approximately nine months they released me as they did not need my services any more.

(Testimony of Guy Woods, Jr.)

Q. They released you subject to recall; is that it?

A. Well, at that time they just released us.

Q. How long had you been practicing, then, before you entered into this agreement, this Exhibit No. 1, with Dr. Butori? How [75] long had you been practicing orthodontia?

A. Since 1949.

Q. About three years, then. And you entered into this profit-sharing agreement with him. What was he to do for you, Doctor?

A. Well, he was to take care of my practice while I was in the service.

Q. How long, Doctor, does it ordinarily take to treat a patient, an orthodontic patient?

A. Well, it depends on the individual case. Probably the average would be 18 months or two years; something like that. Some cases could take less and some more, of course.

Q. Dr. Butori, I take it, took over both the simple cases and the complex cases? He took them all, didn't he?

A. He took them all, and in all stages of treatment.

Q. How long was it, Doctor, before you dissolved that agreement?

The Court: This is Exhibit No. what?

Mr. Pedersen: This is No. 2, your Honor.

The Court: Have you offered No. 1? That is already in evidence, isn't it?

Mr. Pedersen: Yes.

A. This is dated the 27th day of March, 1954, and the other was the 26th day of August of 1952. However, the profit-sharing agreement had actually been in

(Testimony of Guy Woods, Jr.)

effect about a year, because it was, I believe, February of 1953 before I went into the service, [76] or something on that order.

Q. Were you and Dr. Butori working together prior to the time of this agreement, then? You were working together?

A. We worked together for a matter of six weeks or two months, I think. I am not sure exactly.

Q. Prior to the time that you entered into this agreement?

A. Yes.

Q. Now, from the time that Dr. Butori entered into this association with you until the time that you entered into the agreement of partnership, had Dr. Butori treated a number of patients to completion?

A. I don't believe I understand that question.

Q. From the time that you entered into the association with Dr. Butori until the time that you entered into the partnership with Dr. Butori and Rees and yourself, had Dr. Butori completed a number of patients?

A. I assume so. I have no way of knowing the exact number.

Q. No, but you had patients that were close to completion or that would be completed—

A. Oh, he completed some patients within a month or two after I left.

Q. That is what I meant. After he took over he immediately started to complete the patients?

A. That is correct.

Q. Now, after you have completed a patient that has had her [77] teeth straightened—we will say a female patient that has had her teeth straightened, that



(Testimony of Guy Woods, Jr.)

is a good source of contact for new business, isn't it?

A. An excellent source.

Q. What was the situation as to the number of orthodontists that were available in 1954, Doctor?

A. Well, I could name them. I think there must have been about ten or so in Portland.

Q. Did you approach Dr. Rees about the partnership?

A. I did, as I recall.

Q. All right. Now, what was the basis that you were willing to go into a partnership on, Doctor?

A. Well, the basis we went in on was agreeable to him.

Q. That basis was an equal basis; isn't that right?

A. That is correct.

Q. Doctor, did you feel that you had developed your practice and had treated enough patients so that more or less you had patients that had been completed for the purpose of expectation so that you could rely on your practice when you entered into this partnership?

A. Of course I did.

Q. When did you become a member of the American Board of Orthodontists?

A. I believe it was April of 1954.

Q. And you entered into this agreement in March; is that [78] correct?

A. That is correct.

Q. How long did you teach up at the Medical School, Doctor?

A. From 1949 to 1953.

Q. Doctor, what did you feel from the standpoint of good will that Dr. Rees had to offer?

A. He had a tremendous backing as far as stand-

(Testimony of Guy Woods, Jr.)

ing in the community as an orthodontist and as to his standing in the profession.

Q. You mean his reputation was good; is that it?

A. Excellent.

Q. Excellent. Now, how about offices? Did he have anything to offer in the way of an office location or anything that you thought was beneficial or bad?

A. Well, for a single practice where I was was fine, but for a group practice a central location would be necessary, or I felt it would be necessary.

Q. Doctor, referring to Exhibit No. 3, the agreement of sale between Dr. Denton G. Rees, Dr. Butori and yourself, would you examine the agreement, Exhibit 3. How much good will did you agree to pay for in that agreement, Doctor?

The Court: The agreement speaks for itself, Mr. Pedersen.

Mr. Pedersen: All right.

Q. Was it your intent to purchase good will from Dr. Rees by that agreement? [79]

A. It was.

Q. And, so far as you know, it was the intent of Dr. Rees to sell good will? A. It was.

Q. And did the parties, so far as you know, bargain for good will? A. They did.

Q. Now, Doctor, the Government has alleged that the purchase of good will was really an allocation of income, and by reason thereof there has been some money returned to you. Do you have the amount of money that has been returned to you because of your overpayment of taxes?

(Testimony of Guy Woods, Jr.)

A. Yes, I have it—I have some checks in my pocket that have been sitting in the safe deposit box.

Q. Would you indicate what the amounts are, Doctor?

A. There are four checks; one for \$1,258.77, one for \$3,851.66, one for \$565.92, and one for \$346.90.

Q. In other words, Doctor, there is roughly \$5,000 that has been returned to you because you overpaid your income tax?

A. Yes. I believe it is more than that.

The Court: Whatever the figures are. Let's get away from these compilations and get on with the case, Mr. Pedersen.

Mr. Pedersen: All right.

Q. You understand, Doctor, that if the Government is successful in its contention you will have to return this money to [80] Uncle Sam?

A. I do.

Q. You understand that?

A. Yes.

Q. In view of that, it is still your intent that you purchased good will?

A. I did.

Mr. Pedersen: I have no further questions.

### Cross-Examination

By Mr. Biggins:

Q. Would you agree, Dr. Woods, that the group or clinical approach to orthodontics is quite different from individual practice?

A. Yes.

Q. And at the time this instrument, Exhibit 3, was executed, you and Dr. Butori were going from individual practice into the group or clinical practice; that is also true?

A. That is correct.



(Testimony of Guy Woods, Jr.)

Q. As was Dr. Rees going from his individual practice into this group practice?

A. Correct.

Q. One last battery of questions, Dr. Woods. Would you be mindful, sir, of the time that Dr. Butori took over your practice? Would you be mindful of that?  
[81]

A. I don't believe I understand the question.

Q. Just be mindful of the time Dr. Butori took over.

A. You mean think about it?

The Court: Keep it in mind.

Mr. Biggins: Q. Think of how he took over your patients and how he treated them. Now, in comparison to that, think further, if you will, Dr. Woods, about when you and Dr. Butori combined in the group approach with Dr. Rees, and how you took over his patients, if I may still use that expression. Was there any difference, Dr. Woods, and, if so, what?

A. When I left, I left—

Q. From the patients' point of view, is my question.

A. That is what I am trying to explain. I left completely the patients. If they had any problems, they would go directly to Dr. Butori. As of a certain cutoff date he saw the patients from then on. However, when we came back and had the clinic approach, it didn't make any difference who had originally contacted the patient, but from then on we saw them jointly. So that I would see them one time and Dr. Rees the next time and Butori the next time, and so forth.

Q. That is the only difference from your point of

(Testimony of Guy Woods, Jr.)

view? That is about it, in a word, isn't it, Doctor?

A. From the patients' standpoint that is the difference.

Q. There is no doubt in your mind that your arrangement with Dr. Butori was a profit-sharing arrangement? There is no doubt [82] at all about that, is there?

A. Well, it was—we shared the profits. That is right.

Mr. Biggins: All right. That is all. Thank you, Doctor.

Mr. Pedersen: That is all.

(Witness excused.)

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Mr. Pedersen: Your Honor, we have a call in for Dr. Butori.

The Court: Can't you stipulate as to what he would testify to here? I have another case at 1:30, Gentlemen.

Mr. Pedersen: All right.

The Court: Tell us what he would testify to and maybe Mr. Biggins could agree to it, Mr. Pedersen.

Mr. Pedersen: If Dr. Butori were to take the stand, your Honor, he would testify that he entered into an agreement of profit-sharing with Dr. Woods.

The Court: That is the agreement that is in evidence?

Mr. Pedersen: That is the agreement that is in evidence.

The Court: As Exhibit No. 1?

Mr. Biggins: There is no dispute about that, that during the time he was in association—

Mr. Pedersen: Secondly, that Dr. Woods completed a number of patients over the period he was a neophyte, more or less, of [83] a practitioner—

Mr. Biggins: I will accept the first part of that, that he did complete a number of Dr. Woods' patients. Whether he was a neophyte or not—

The Court: No, I wouldn't permit him to testify to that, anyway, because that would be the doctor's own conclusion on it.

Mr. Pedersen: Thirdly, his testimony would indicate that he intended to purchase good will from Dr. Rees; that he bargained for good will, and that good will was a consideration, just as the agreement has been introduced into evidence here.

Mr. Biggins: I have no doubt if called as a witness he would so testify, with the understanding, of course, we are not bound by the characterizations or conclusions of the witness.

The Court: That is right.

Mr. Biggins: But that he would so testify.

The Court: Yes. You will agree to those things, Mr. Biggins?

Mr. Biggins: That he would so testify; yes, your Honor.

The Court: That he would so testify.

Mr. Biggins: Reserving, of course, that I am not bound by those characterizations.

The Court: Oh, no. I realize that.

Mr. Biggins: All right. I would agree.

The Court: Anything else, Mr. Pedersen? [84]



Mr. Pedersen: No, other than, fourth, that he would testify he was intending to purchase good will, and he has paid for it; he has paid for good will, and he would further testify that likewise he requested his excess of \$5,000 that is his money, and that has been returned because of the Government's position. And he would likewise say, irrespective of that fact, that it was his intent to purchase good will, notwithstanding that it would cost him \$5,000 to so testify, more or less.

The Court: You will agree if he was called he would so testify?

Mr. Biggins: Yes, as to the part relating to good will, with the same reservations again as to the characterizations.

The Court: Yes.

Mr. Biggins: All right.

Mr. Pedersen: That is it.

Mr. Biggins: I take it the plaintiff rests and the Government has no evidence to offer.

The Court: What is your pleasure with reference to submission?

Mr. Pedersen: I have prepared in the claim for refund, your Honor, a legal memorandum on this question of good will. The Government is contending flatly that a professional man just cannot have good will.

Mr. Biggins: I believe the Court wants to know when we [85] will have our briefs in.

The Court: Yes. I assume you want to file a brief, Mr. Pedersen?

Mr. Pedersen: Yes. I would like to file a brief on—do you want to cover the point of the club expense?

Mr. Biggins: I think I will cover whatever we want

to in the briefs. The Court simply wants to know the time. Do you want 30 days or two weeks?

Mr. Pedersen: 30 days would be fine, your Honor.

The Court: You want 30 days, Mr. Pedersen?

Mr. Pedersen: Yes, I can file a brief within 30 days.

The Court: The Government will require what time?

Mr. Biggins: Certainly I ought to have it in in two weeks after I receive their brief.

The Court: Then we will allow you ten days after that for a reply brief.

(Whereupon proceedings in the above matter were concluded.)

[86]

[Endorsed]: Filed August 26, 1960.

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[Endorsed]: No. 17348. United States Court of Appeals for the Ninth Circuit. United States of America, Appellant, v. Denton J. Rees and Kathryn G. Rees, Appellees. Transcript of Record. Appeal from the United States District Court for the District of Oregon.

Filed: April 22, 1961.

Docketed: April 27, 1961.

/s/ FRANK H. SCHMID,  
Clerk of the United States Court of Appeals for the  
Ninth Circuit.

In the United States Court of Appeals  
for the Ninth Circuit

No. 17,348

UNITED STATES OF AMERICA,

Appellant.

v.

DENTON J. and KATHRYN G. REES,

Appellee.

## APPELLANT'S STATEMENT OF POINTS

### I.

The District Court erred in holding that income of \$35,000, paid or payable to the taxpayer pursuant to a contract by which he purportedly sold professional good will, was capital gain.

### II.

The District Court erred in holding that income of \$35,000, paid or payable to the taxpayer pursuant to a contract by which he purportedly sold professional good will, was received solely for good will.

### III.

The District Court erred in including in the amount allegedly paid for good will sums representing payment for elements not properly includible therein.



## IV.

The District Court erred in failing to hold that sums representing payments to the taxpayer for items not properly includible in good will were taxable as ordinary income.

## V.

The taxpayer failed to meet his burden of proving a sale of good will or the market value thereof.

Dated: May 24, 1961.

/s/ JOHN B. JONES, JR.

Acting Assistant Attorney General.

[Endorsed]: Filed May 26, 1961. Frank H. Schmid, Clerk.

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No. 17,349

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

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SIMONE SCOZZARI,

*Appellant,*

VS.

GEORGE K. ROSENBERG, District Director  
Immigration and Naturalization  
Service, Los Angeles, California,

*Appellee.*

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**BRIEF FOR APPELLANT.**

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No. 17,349

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

---

SIMONE SCOZZARI,

*Appellant,*

VS.

GEORGE K. ROSENBERG, District Director  
Immigration and Naturalization  
Service, Los Angeles, California,

*Appellee.*

---

**BRIEF FOR APPELLANT.**

---

**JURISDICTIONAL STATEMENT.**

On December 30, 1960 there was filed in the United States District Court for the Southern District of California, Central Division, on behalf of Simone Scozzari, hereinafter referred to as appellant, a declaratory judgment action seeking judicial review of an administrative decision (T. 3). On the 3rd day of February, 1961, the defendant, District Director of the Immigration and Naturalization Service, hereinafter referred to as appellee, by and through his counsel, filed in the United States District Court a motion for summary judgment (T. 7). Findings of

Fact, conclusions of law and judgment adverse to appellant and granting appellee's motion for summary judgment were filed on March 10, 1961 and entered on March 13, 1961 (T. 8-15). Notice of appeal was filed on April 13, 1961 (T. 62).

Jurisdiction of the District Court to entertain the declaratory judgment action is conferred by Section 10 of the Act of June 11, 1946 (Administrative Procedure Act), 60 Stat. 243, 5 U.S.C.A., Sec. 1009. Jurisdiction of the Court of Appeals to review the District Court's final order is conferred by 28 U.S.C.A. 1291 and 1294.

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#### **STATUTE INVOLVED.**

Title 8, U.S.C.A. 1259.

“Record of admission for permanent residence in the case of certain aliens who entered the United States prior to June 28, 1940.

A record of lawful admission for permanent residence may, in the discretion of the Attorney General and under such regulations as he may prescribe, be made in the case of any alien, as of the date of the approval of his application or, if entry occurred prior to July 1, 1924, as of the date of such entry, if no such record is otherwise available and such alien shall satisfy the Attorney General that he is not inadmissible under section 1182(a) of this title insofar as it relates to criminals, procurers and other immoral persons, subversives, violators of the narcotic laws or smugglers of aliens, and he establishes that he—



- (a) entered the United States prior to June 28, 1940;
  - (b) has had his residence in the United States continuously since such entry;
  - (c) is a person of good moral character; and
  - (d) is not ineligible to citizenship.”
- 

#### **STATEMENT OF THE CASE.**

Appellant is an alien, a native and citizen of Italy, who entered the United States as a stowaway in about 1923. On January 21, 1958, the appellee served upon appellant an order to show cause and notice of hearing. Upon insistence of counsel, the matter was continued by appellee until January 31, 1958, at which time a hearing in deportation proceedings was conducted by subordinate officials of the appellee herein. At the conclusion of that proceeding, it was directed that appellant be deported from the United States. On appeal from said adverse decision, the Board of Immigration Appeals *inter alia*, under date of July 2, 1958, directed that the case of appellant herein be remanded to the Immigration and Naturalization Service for the purpose of affording appellant an opportunity to file an application to create a record of lawful entry into the United States for permanent residence, pursuant to the provisions of Section 249 of the Immigration and Nationality Act (8 U.S.C.A. 1259). On September 8, 1958, appellant filed, on an appropriate form provided by the Immigration and Naturalization Service, an application to create a

record of admission for permanent residence under Section 249 of the Immigration and Nationality Act (T. 16-19). As part of an alleged hearing conducted in connection therewith, a sworn statement was taken from appellant on December 10, 1958 (T. 21-50). In support of his claim, appellant submitted the certificate of his marriage to a United States citizen (T. 52), the birth record of his wife (T. 51), a letter of Mr. A. M. Alberti (T. 53), and affidavits of two witnesses who appeared at the Los Angeles Office of the Immigration and Naturalization Service (T. 54-56). Said application was denied by the District Director, Immigration and Naturalization Service, Los Angeles, on March 6, 1959 (T. 56-59), and affirmed by the Acting Regional Commissioner, following appeal, on April 1, 1959 (T. 60-62). The declaratory judgment suit was filed in the United States District Court seeking review of the foregoing administrative action.

---

#### **STATEMENT OF POINTS ON APPEAL.**

1. The District Court erred in holding that the appellant was given a fair hearing, as required by the "due process of law" clause of the Fifth Amendment to the Constitution of the United States.

2. The District Court erred in holding that the action of the Immigration and Naturalization Service denying appellant's application to create a record of lawful admission for permanent residence was neither arbitrary nor capricious.

3. The District Court erred in holding that the action of the Immigration and Naturalization Service denying appellant's application to create a record of admission for permanent residence was not an abuse of discretion.

4. The District Court erred in holding that the proceedings conducted by the Immigration and Naturalization Service, relating to the appellant's application to create a record of admission for lawful permanent residence, were fair and were in accordance with law.

5. The District Court erred in holding that the decisions of the Immigration and Naturalization Service denying appellant's application to create a record of admission for permanent residence were based on any reasonable, substantive or probative evidence.

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### **ARGUMENT**

This matter is before the Court of Appeals to review the summary judgment of the District Court entered in favor of defendant-appellee and against plaintiff-appellant. In the action below, appellant sought to have all actions and decisions of the appellee pertaining to rejection of appellant's application for adjustment of status under Section 249 of the Immigration and Nationality Act (8 USCA 1259) reviewed and to have said application remanded to the District Director of the Immigration and Naturalization Service for further consideration.



An immigration administrative decision is subject to judicial review where the proceedings have not conformed to the traditional standards of fairness required by the due process of law clause of the Fifth Amendment to the Constitution of the United States. *Japanese Immigrant Case*, 189 U.S. 86, 47 L. Ed. 721, 725, 23 S. Ct. 611; *Vajtauer v. Commissioner of Immigration*, 273 U.S. 103, 71 L. Ed. 560, 563, 47 S. Ct. 302; *Wong Yang Sung v. McGrath*, 339 U.S. 23, 94 L. Ed. 616, 628, 70 S. Ct. 445; *Kwong Hai Chew v. Colding*, 344 U.S. 590, 97 L. Ed. 576, 584, 73 S. Ct. 472. Or where there has been arbitrariness or abuse of discretion by the administrative agency. *Low Wah Suey v. Backus*, 225 U.S. 460, 56 L. Ed. 1165, 1167, 32 S. Ct. 734; *Kwock Jan Fat*, 253 U.S. 464, 64 L. Ed. 1010, 1014, 40 S. Ct. 566; *Carlson v. Landon*, 342 U.S. 524, 96 L. Ed. 547, 558, 72 S. Ct. 525; *Yaris v. Esperdy* 202 F. 2d 109, 112. The same general rule applies to determine whether or not the law has been correctly applied. *Gegiow v. Uhl*, 239 U.S. 3, 60 L. Ed. 114, 118, 36 S. Ct. 2; *Kessler v. Strecker*, 307 U.S. 22, 83 L. Ed. 1083, 1090, 59 S. Ct. 694; *Bridges v. Wixon*, 326 U.S. 135, 89 L. Ed. 2103, 2116, 65 S. Ct. 1443; *Fong Haw Tan v. Phelan*, 333 U.S. 6, 92 L. Ed. 433, 436, 68 S. Ct. 374. Cf. *McGrath v. Kristensen*, 340 U.S. 162, 95 L. Ed. 173, 181, 71 S. Ct. 224.

Such agency action is reviewable under Section 10 of the Administrative Procedure Act (5 USCA 1009). The Administrative Procedure Act authorizes review by the Court and inquiry as to the fairness of the hearing, whether the agency acted capriciously, arbi-

trarily or abused its discretion and as to whether the order of the agency was supported by substantial evidence (5 USCA 1009(e)). *Shaughnessy v. Pedreiro*, 349 U.S. 48, 99 L. Ed. 868, 75 S. Ct. 591; *Brownell v. Tom Wee Shung*, 352 U.S. 180, 1 L. Ed. 2d 225, 77 S. Ct. 252.

The Court, in a proceeding to review under the Administrative Procedure Act, is not permitted to hear the case de novo. The case must be heard on the record. 5 USCA 1009(e). The entire record relating to appellant's application filed under the provisions of Section 249, supra, is fully set forth in the transcript of the record, pages 12-62, inclusive. We have amply defined, by the cases cited, the jurisdiction of the lower Court and this Court and the power of the Courts to protect the rights of all individuals in conformity with the fundamental principles of justice as embraced within the Constitution of this nation. Quaere: Applying those standards to the case at bar, does this record justify judicial intervention?

The issues are so co-mingled that it is impossible to differentiate arguendo—fairness of hearing, arbitrary or capricious action, manifest abuse of discretion and a decision unsupported by substantial evidence. Hence, it is impossible to argue these questions independently.

Even though a judicial precedent directly on point can not be found, it is asserted that by analogy precedent decisions relating to other immigration proceedings are pertinent in determining whether a fair hearing was conducted in the instant matter. It has been



stated that an alien who has entered the United States, even though illegally, may be expelled only after proceedings conforming to the traditional standards of fairness as encompassed in the due process of law clause. *Shaughnessy v. Mezei*, 345 U.S. 206, 97 L. Ed. 956, 73 S. Ct. 625. *U. S. v. Murff* (2 Cir.), 260 F. 2d 610. The latter case involved an alien whose parole into the United States had been revoked without a hearing. However, the Court concluded that the Constitution required a hearing prior to revocation of parole, 260 F. 2d 614.

“When the Constitution requires a hearing, it requires a fair one, one before a tribunal which meets at least current prevailing standards of impartiality.”

*Wong Yang Sung v. McGrath*, 339 U.S. 33, 50, 94 L. Ed. 616, 70 S. Ct. 445.

A review of the record here presents a serious question as to whether this form of processing an application for adjustment of status complies with the Administrative Procedure Act and the procedural due process of law requirement. No hearing as such was ever conducted by the Immigration and Naturalization Service. The application was filed, the appellant and two witnesses were interrogated by an Immigrant Inspector and a decision followed.

In *Bridges v. Wixon*, 326 U.S. 135, 89 L. Ed. 2103, 65 S. Ct. 1443, the Supreme Court of the United States, at page 154, stated:

“Meticulous care must be exercised lest the procedure by which he is deprived of that liberty not meet the essential standards of fairness.”



It is submitted that this in itself is sufficient to justify reversal of the decision below on the ground that such agency action does not meet the minimum procedural requirements.

The Fifth Amendment to the Constitution of the United States provides that:

“No person shall \* \* \* be deprived of life, liberty, or property, without due process of law,”

An alien is a person entitled to protection under that due process of law clause. *Galvan v. Press*, 347 U.S. 522, 98 L. Ed. 911, 74 S. Ct. 737. We assert that there was here an invasion of that Constitutional right by the Immigration and Naturalization Service. It is within the province of the Courts to test the validity of oppressive administrative action in a declaratory judgment suit. This action was brought for that specific purpose.

In *Stack v. Boyle*, 342 U.S. 1, 6, 96 L. Ed. 3, 72 S. Ct. 1, Mr. Chief Justice Vinson warned that we should not “inject into our own system of Government the very principles of totalitarianism which Congress was seeking to guard against \* \* \*.” This warning is particularly appropriate in the setting of the instant case.

Appellee denied appellant's requested relief, setting forth in his decisions the reasons for such action. The cited disqualifying factors thus relied upon are unsupported and find no basis in the record. The administrative decisions are arbitrary, capricious and unsupported by the evidence. Appellee refers to an alleged meeting at Apalachin, New York, the fact that some

60 individuals representative of the criminal element in the United States attended; that the appellant was accompanied to Apalachin by Frank Desimone, a well known figure among the criminal element in Southern California; that the said Frank Desimone was recently convicted of contempt of Court, and that the appellant admits association with many other persons publicly known to have police records (T. 59). The administrative record fails to show that appellant's association with any or all of the named individuals reflected on his character; there is no evidence as to the present or past activities of the individuals concerned about whom he was questioned. More important, the questions did not go to the period of association, the extent of such association, nor appellant's knowledge concerning the background or records of the parties concerned. There is no evidence of record to establish that Frank Desimone was a well known figure among the criminal element in Southern California, nor that he was recently convicted of contempt of Court, if that at all has any bearing upon this case. Matter of fact, judicial records will show that such contempt of Court citation was reversed and set aside on appeal. The Court of Appeals for the Second Circuit in a recent decision found that there was absolutely no evidence to support a finding that there was a meeting for any criminal purpose at Apalachin, New York in November, 1957.

In *Konigsburg v. State Bar of California*, 353 U.S. 252, 267, 268, 1 L. Ed. 2d 810, 77 S. Ct. 722, the Supreme Court of the United States stated:



“There was no evidence that he was engaged in or abetted any unlawful or immoral activities—or even that he knew of or supported any actions of this nature. It may be, although there is no evidence before us to that effect, that some members of that party were involved in illegal or disloyal activities but petitioner can not be swept into this group solely on the basis of an alleged membership in that party.”

We submit that it is fully in accord with American traditions and numerous judicial rulings to state that this country does not normally establish guilt by association alone. A man is evaluated on the basis of his individual merit, on performance and conduct and not on the basis of those with whom he has been associated in the past. It is not unreasonable to demand a fair and impartial determination—not a decision based upon inference, speculation or conjecture.

In *United States v. Murff*, 2 Cir. 260 F. 2d 610, the Court at page 615 stated:

“We do say that there must be a hearing which will give assurance that the discretion of the Attorney General shall be exercised against a background of facts fairly contested in the open.”

This Court, in *Cherneckoff v. United States*, 219 F. 2d 721 at page 723, stated:

“The fair hearing essential to meet minimum requirements of any accepted notion of due process includes the opportunity to know of adverse evidence and to be heard concerning its truth, rele-



vancy and significance. Otherwise such a hearing is in violation of the 'concept of ordered liberty',

\* \* \*''.

Also compare:

*Takeo Tadano v. Manney*, 9 Cir. 160 F. 2d 665, 667.

In addition to the foregoing, appellee comments upon appellant's relationship with his wife prior to their marriage and to his arrest record. Similar facts relating to premarital relationship were considered and decided adversely to the Immigration and Naturalization Service by the Court of Appeals for the Second Circuit in *Posusta v. United States*, 285 F. 2d 533. The appellant has not been convicted of any offense involving moral turpitude, and he certainly should not be precluded from the relief sought solely upon the basis of his arrest record. Section 249 was remedial legislation designed to afford an alien unlawfully in the United States an opportunity to adjust his status, for humane reasons, to that of a lawful permanent resident. As a general rule, remedial legislation, such as this particular section of law, is to be liberally construed. *Sutherland on Statutory Construction*, Third Edition, Volume II, Section 3302.

It is well recognized that administrative decisions are not binding upon the Courts. However, we believe that the statutory language of the Immigration and Nationality Act and such administrative decisions should be given some weight and consideration in reaching a determination concerning this matter. The Immigration and Naturalization Service has ruled in

published precedent decisions that an alien convicted of a petty offense which does involve moral turpitude is not precluded from establishing good moral character. Matter of M——, 7 I&N Dec. 147; Matter of H——, 6 I&N Dec. 738. Such action is justified under the actual language of Section 4 of the Act of September 3, 1954 (68 Stat. 1145), at which time Congress enacted legislation making such individuals eligible for admission to the United States for permanent residence. The comments of the Service in its decision here establishes a fundamental inequality, prejudicial to appellant. Therefore, it must be concluded that the administrative decision was arbitrary and capricious and that the reasons set forth are unsupported by any evidence whatsoever.

The statute herein, admittedly, grants the Attorney General discretionary powers. By regulation, the Attorney General has delegated such authority to his subordinate administrative officials. However, we believe it now well settled that such authority is subject to judicial review in appropriate cases.

In *Kwock Jan Fat v. White*, 253 U.S. 454, 64 L. Ed. 1010, 40 S. Ct. 566, after discussing the great power of the Secretary of Labor over Chinese immigrants, the Court said:

“\* \* \* is a power to be administered, not arbitrarily or secretly, but fairly and openly under the restraints and principles of free government applicable where the fundamental rights of men are involved, regardless of their origins or race. It is the province of the Courts, in proceedings

for review \* \* \* to prevent abuse of this extraordinary power, \* \* \*.”

Any delegated executive power is subject to conformance with the due process clause of the Fifth Amendment. *Ex parte Endo*, 323 U.S. 293, 89 L. Ed. 243, 65 S. Ct. 208. Any exercise of discretion must be consistent “with the fundamental principles of justice embraced within the conception of the due process of law.” *Tang Tung v. Edsell*, 223 U.S. 673, 56 L. Ed. 606; *Joint Fascist Refugee Comm. v. McGrath*, 341 U.S. 123, 95 L. Ed. 817, 71 S. Ct. 624; *Carlson v. Landon*, 342 U.S. 524, 96 L. Ed. 547, 72 S. Ct. 525, rehearing denied 343 U.S. 988.

The discretionary acts of an administrative agency may be reviewed on motions for summary judgment.

*Ullah v. Hoy*, 9 Cir., 278 F. 2d 194 ,196;

*Miyaki v. Robinson*, 7 Cir., 257 F. 2d 806, cert. denied 358 U.S. 894;

*Aletiou v. Rodgers* (D.C.), 254 F. 2d 782.

A review of the record in the instant case reflects a manifest abuse of administrative discretion.



### CONCLUSIONS

The administrative decision is not supported by any reasonable, substantial or probative evidence. It is without question an arbitrary and capricious decision in distinct violation of our Constitutional safeguards. It is the inescapable duty of the Courts, as free and responsible moral agents of this country, to use everything within their power to force administrative compliance with the mandates of the Constitution and statutes of the United States.

In *U. S. v. Morton Salt Company*, 338 U.S. 632, 94 L. Ed. 401, 70 S. Ct. 357, the Supreme Court in referring to the Administrative Procedure Act, at page 644, observed that:

“It created safeguards even narrower than the Constitutional ones, against arbitrary official encroachment on private rights.”

Those are not nebulous words and their miscarriage must be jealously guarded against by the Courts in order to prevent persistent erosion of the protection afforded by the Fifth Amendment and the Administrative Procedure Act.

Even though we are not confronted in the instant case with an order of deportation, rejection of the application for adjustment of status is tantamount to banishment of this alien from the United States, and, as the Supreme Court has so succinctly stated on numerous occasions, deportation may result in the loss of all that makes life worth living.

Judicial intervention is appropriate herein in order to prevent abuse of the extraordinary administrative power. Appellant should be accorded a hearing which clearly meets the fundamental principles of justice.

It is respectfully submitted that the decision below should be reversed.

Dated, San Francisco, California,

July 6, 1961.

Respectfully submitted,

G. VERNON BRUMBAUGH,

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By JOSEPH S. HERTOGS,

*Attorneys for Appellant.*

No. 17349

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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SIMONE SCOZZARI,

*Appellant,*

*vs.*

GEORGE K. ROSENBERG, District Director, Immigration  
and Naturalization Service, Los Angeles District,

*Appellee.*

---

## BRIEF FOR APPELLEE.

---

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No. 17349

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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SIMONE SCOZZARI,

*Appellant,*

*vs.*

GEORGE K. ROSENBERG, District Director, Immigration  
and Naturalization Service, Los Angeles District,

*Appellee.*

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## BRIEF FOR APPELLEE.

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### Jurisdiction.

Appellant brought action in the court below [T. 3-5],<sup>1</sup> praying for a judgment declaring that the order and decision denying his application under Section

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<sup>1</sup>"T." indicates references to the printed Transcript of Record, and "Br." refers to Appellant's Opening Brief. This Court, by its Order Denying Motion to Dismiss Appeal, etc. [T. 66-67] provided for printing of the record "excluding original exhibits" [T. 67]; and by Stipulation and Order filed in this Court on May 5, 1961, it was provided that exhibits might be considered in their original form without printing. Thus, although a portion of the record of the Immigration and Naturalization Service, which was attached to appellee's Motion for Summary Judgment [T. 7] as Exhibit "A," has been printed, references will be made in this brief to other portions of that record which were not printed, as indicated hereinafter.

"Ex." followed by a number refers to numbered exhibits which were received in evidence at appellant's deportation hearings. These exhibits sometimes consist of several pages; and where appropriate, page numbers are given after the exhibit number. "R." refers to page numbers of the record of appellant's deportation hearings contained in Exhibit "A." Where portions of Exhibit "A" have been printed, references to the printed Transcript of Record will be placed in parentheses after references to the original record, *e. g.* [Ex. 16, p. 1 (T. 21)].

249 of the Immigration and Nationality Act is illegal and void and a denial of due process of law, and restraining his deportation pending outcome of the litigation [T. 5].

The District Court had jurisdiction of appellant's action under the provisions of Section 10 of the Act of June 11, 1946 (Administrative Procedure Act), 60 Stat. 243, 5 U. S. C. A. §1009. Since the judgment of the District Court [T. 15] is a final decision, this Court has jurisdiction of the present appeal from that decision under the provisions of Title 28, U. S. Code, Sections 1291 and 1294(1).

### Statement of the Case.

Appellant is an alien, a native and national of Italy [Ex. 1; R. 2; Ex. 16, p. 2 (T. 22-23)]. He entered the United States as a stowaway, without inspection, and without a passport or other entry document [Ex. 16, p. 3 (T. 23); R. 4, 8]. He claims to have entered during 1923 and to have resided in the United States continuously since that time [Ex. 16, pp. 2, 4 (T. 23, 25); R. 4, 12].

On January 21, 1958 an Order to Show Cause and Notice of Hearing was issued and served upon the appellant, charging, *inter alia*, that appellant was subject to be taken into custody and deported pursuant to Sections 241(a)(1), 241(a)(2), and 241(a)(5) of the Immigration and Nationality Act [Ex. 1]. Pursuant to this Order to Show Cause and Notice of Hearing, a deportation hearing was held at Los Angeles, California on January 31, 1958 [R. 1-31]. At this hearing two additional charges were lodged against the appellant under Section 241(a)(1) of the Immigration



and Nationality Act [R. 29-30; Ex. 14]. On February 12, 1958 the Special Inquiry Officer who presided at this deportation hearing rendered his decision ordering that the appellant be deported from the United States in the manner provided by law on the charges contained in the Order to Show Cause and on the additional lodged charges [See decision in Ex. "A"].

Appellant appealed the Special Inquiry Officer's decision of February 12, 1958 to the Board of Immigration Appeals, United States Department of Justice. On July 2, 1958 that Board held, *inter alia*, that the charge under Section 241(a)(5) of the Immigration and Nationality Act and one of the charges under Section 241(a)(1) of that Act were not sustained, and directed that the case be remanded to the Special Inquiry Officer for the purpose of permitting appellant to file an application for a record of lawful admission under the provisions of Section 249 of the Immigration and Nationality Act [See decision in Ex. "A"].

On September 8, 1958 appellant filed with the Immigration and Naturalization Service, Los Angeles, California, an Application to Create Record of Admission for Permanent Residence under Section 249 of the Immigration and Nationality Act [Ex. 15 (T. 16-19)]; and on December 10, 1958 evidence relating to this application was taken by an Immigrant Inspector [Ex. 16 (T. 21-50), Ex. (T. 51), and Ex. 22 (T. 52); also see documents following Ex. 14 (T. 53-56)]. On March 6, 1959 appellant's application was denied by the District Director, Immigration and Naturalization Service, Los Angeles, California on the ground that appellant had failed to establish that he was a person of good moral character [Ex. (T. 56-59)]. On

April 1, 1959 this denial was affirmed by the Acting Regional Commissioner, Southwest Region, Immigration and Naturalization Service upon the ground (1) that appellant had failed to sustain the burden of proof which was upon him of establishing that he was a person of good moral character, and (2) in the exercise of the administrative discretion conferred by the provisions of Section 249 [Ex. 18 (T. 60-62)].

On May 18, 1959 appellant's deportation hearing was resumed at Los Angeles, California before the Special Inquiry Officer who had presided at the earlier hearing. At this continued hearing there was received in evidence, *inter alia*, documents relating to appellant's Application to Create Record of Admission for Permanent Residence [Exs. 15 (T. 16-19), 16 (T. 21-50), 17 (T. 56-59), and 18 (T. 60-62); R. 34-35] and an Application for Pre-examination, which appellant had previously filed on November 26, 1958 [Ex. 19].<sup>2</sup> On May 29, 1959 the Special Inquiry Officer rendered his decision ordering, *inter alia*, that appellant's application for preexamination be denied and that appellant be deported from the United States in the manner provided by law on the following charges [See Decision in Ex. "A"].

(1) Under Section 241(a)(2) of the Immigration and Nationality Act in that he entered the United States without inspection;

(2) Under Section 241 (a)(1) of the Immigration and Nationality Act in that at the time of entry, he was within one or more of the classes of

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<sup>28</sup> C. F. R. 235 a.1, 23 F. R. 8395, which authorized pre-examination under certain circumstances was revoked effective August 11, 1959 [see 24 F. R. 6477].

aliens excludable by the law existing at the time of such entry, to wit: a stowaway, under Section 3 of the Act of February 5, 1917;

(3) Under Section 241(a)(1) of the Immigration and Nationality Act in that at the time of entry he was within one or more of the classes of aliens excludable by the law existing at the time of such entry, to wit: a person who has not presented an unexpired passport or official document in the nature of a passport issued by the government of the country to which he owes allegiance, or other travel document showing his origin and identity, as required by the Passport Act of May 22, 1918, and the Executive Order in effect at time of entry.

Appellant appealed the Special Inquiry Officer's decision of May 29, 1959 to the Board of Immigration Appeals, United States Department of Justice; and on September 28, 1959 this Board ordered that no change be made in the order of the Special Inquiry Officer and that the appeal be dismissed [See decision in Ex. "A"].

On December 30, 1960 appellant instituted the present action [T. 3-5]. In his complaint filed in the District Court appellant did not *per se* challenge the order of deportation outstanding against him; but complained solely of the denial of his Application to Create Record of Admission for Permanent Residence under Section 249 of the Immigration and Nationality Act [T. 4-5].

On February 3, 1961 appellee moved for summary judgment [T. 6-7]; and on March 13, 1961 the Dis-



trict Court entered its Findings of Fact, Conclusions of Law, and Judgment, granting summary judgment in favor of appellee [T. 8-15].<sup>3</sup> The present appeal is from that judgment.

### Statute and Regulations Involved.

Section 249 of the Immigration and Nationality Act, 66 Stat. 219, as amended by Public Law 85-616, approved August 8, 1958, 72 Stat. 546, 8 U. S. C. A. §1259 (See 1960 Cumulative Annual Pocket Part), provides:

“§1259. *Record of admission for permanent residence in the case of certain aliens who entered the United States prior to June 28, 1940.*

A record of lawful admission for permanent residence may, in the discretion of the Attorney General and under such regulations as he may prescribe, be made in the case of any alien, as of the date of the approval of his application or, if entry occurred prior to July 1, 1924, as of the date of such entry, if no such record is otherwise available and such alien shall satisfy the Attorney Gen-

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<sup>3</sup>Deportation orders, not generally raising any issues of fact for trial *de novo* in the District Court, are frequently reviewed on motions for summary judgment, whether or not applications for discretionary relief are involved. [*Miyaki v. Robinson*, 257 F. 2d 806 (7th Cir. 1958), cert. den. 358 U. S. 894; *Alexiou v. Rogers*, 254 F. 2d 782 (Dist. Col. Cir. 1958); *Nani v. Brownell*, 247 F. 2d 103 (Dist. Col. Cir. 1957), cert. den. 355 U. S. 870; *Vichos v. Brownell*, 230 F. 2d 45 (Dist. Col. Cir. 1958); *Melachrinou v. Brownell*, 230 F. 2d 42 (Dist. Col. Cir. 1956); *Asikese v. Brownell*, 230 F. 2d 34 (Dist. Col. Cir. 1956)]. The use of the summary judgment procedure seems to be particularly appropriate where the only challenge is to the propriety of the denial of discretionary relief [*Civadelic v. Bouchard*, 185 Fed. Supp. 439 (D. C. New Jersey 1960); *Sit Jay Sing v. Nice*, 182 Fed. Supp. 292 (N. D. Calif. 1960)].

eral that he is not inadmissible under section 1182(a) of this title insofar as it relates to criminals, procurers and other immoral persons, subversives, violators of the narcotic laws or smugglers of aliens, and he establishes that he—

(a) entered the United States prior to June 28, 1940;

(b) has had his residence in the United States continuously since such entry;

(c) is a person of good moral character; and

(d) is not ineligible to citizenship.”

Effective August 23, 1958,<sup>4</sup> 8 C. F. R. 249.1, 23 F. R. 6545, provided as follows:

“Part 249—*Creation of Record of Lawful Admission for Permanent Residence.*

§249.1 *Application.* Any alien who believes that he meets the eligibility requirements enumerated in section 249 of the act shall apply on Form N-105 to the district director having jurisdiction over his place of residence. The applicant shall be notified of the decision and if the application is denied of the reasons therefor and of his right to appeal within 10 days from the receipt of such notification in accordance with Part 7 of this chapter. If the application is granted, a Form I-151, showing that the applicant has acquired the

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<sup>4</sup>There were minor changes in this regulation after plaintiff filed his application and before it was finally passed upon by the Acting Regional Commissioner. These changes, which are reviewed in Title 8, Code of Federal Regulations, Part 249.1, 1960 Cumulative Pocket Supplement, are not deemed material; however, it should be noted that effective November 26, 1958 “Part 7” of the second sentence of 8 C. F. R. 249.1 quoted above was changed to “Part 103” (23 F. R. 9124).

status of an alien lawfully admitted for permanent residence, shall not be issued until the applicant surrenders any other document in his possession evidencing compliance with the alien registration requirements of former or existing law.”

Effective November 26, 1958, 8 C. F. R. 103.2, 23 F. R. 9121 provided as follows:

“§103.2 *Formal applications and petitions.* Every formal application or petition shall be filed in accordance with the instructions contained thereon, such instructions being hereby incorporated into the particular section of the regulations requiring its submission. A person or guardian may file on behalf of a son, daughter, or ward under 14 years of age. Any required oath may be administered by an immigration officer or person generally authorized to administer oaths. The decision-rendering Service officer may, in his discretion, require the submission of additional evidence, including blood tests, may require the taking of testimony, and may direct the making of any necessary investigation. Any allegations made in addition to, or in substitution for, those originally made shall be made under oath and filed in the same manner as the original application or petition or noted on the original application or petition and acknowledged under oath thereon. Formal applications or petitions received in any Service office shall be stamped to show the time and date of their actual receipt and shall be regarded as filed when so stamped unless returned because they are improperly executed. Foreign language documents submitted shall be accompanied by certified English translations.”



### Issues Presented.

1. Were the proceedings relating to appellant's Application to Create Record of Admission for Permanent Residence fair, in accordance with law, and in conformity with due process of law?

a. Was appellant entitled to a hearing on his application as contemplated by the Administrative Procedure Act?

b. Was the record of appellant's deportation proceedings properly considered by the officials who decided appellant's application?

c. Is reasonable, substantial, and probative evidence required to support the finding that appellant failed to establish that he is a person of good moral character?

d. If required, does the record contain reasonable, substantial and probative evidence to support the finding that appellant failed to establish that he is a person of good moral character?

e. Was the denial of appellant's application, in the exercise of discretion by the Acting Regional Commissioner, arbitrary, capricious, or an abuse of discretion?

## ARGUMENT.

### I.

The Proceedings Relating to Appellant's Application to Create Record of Admission for Permanent Residence Were Fair, in Accordance With Law, and in Conformity With Due Process of Law.

**A. Appellant's Application Invoked the Discretion of the Attorney General, and Review of the Decision Thereon Is Confined Within Narrow Limits.**

Appellee has found only a few decisions construing Section 249 of the Immigration and Nationality Act [*Weiss v. Esperdy*, ..... F. Supp. .... (S.D. N.Y., March 7, 1961—not reported); *Chan Wing Cheung v. Hagerly*, 192 F. Supp. 452 (D. C. R. I. 1961); *Lum Chong v. Esperdy*, 191 F. Supp. 935 (S.D. N.Y. 1961); *Sit Jay Sing v. Nice*, 182 F. Supp. 292 (N. D. Calif. 1960)] and its predecessor, Section 1 of the Act of March 2, 1929, 45 Stat. 1512 [*United States v. Anastasio*, 120 F. Supp. 435 (D. C. New Jersey 1954), reversed on other grounds 226 F. 2d 912, cert. den. 351 U. S. 931; *Linklater v. Perkins*, 74 F. 2d 473 (Dist. Col. Cir. 1934); *Conti v. Tillinghast*, 1 F. Supp. 981 (D. C. Mass. 1932)].

However, the language of Section 249 on its face reveals that decision upon an application thereunder is “in the discretion of the Attorney General”;<sup>5</sup> as under Section 1 of the Act of March 2, 1929 decision was discretionary with the Commissioner General of Immi-

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<sup>5</sup>This discretion of the Attorney General was by regulation delegated to District Directors “under the executive direction of a regional commissioner” [8 C. F. R. 103.1(f), 23 F. R. 9120].

gration [*Linklater v. Perkins, supra*]. Review of such discretion is confined within narrow limits [Cf. *Jay v. Boyd*, 351 U. S. 345 (1956); *Chao-Ling Wang v. Pilliod*, 285 F. 2d 517 (7th Cir. 1960); *Obrenovic v. Pilliod*, 282 F. 2d 874 (7th Cir. 1960); *Kam Ng v. Pilliod*, 279 F. 2d 207 (7th Cir. 1960), cert. den. 365 U. S. 860; *MacKay v. McAlexander*, 268 F. 2d 35 (9th Cir. 1959), cert. den. 362 U. S. 961; *Cakmar v. Hoy*, 265 F. 2d 59 (9th Cir. 1959); *Fugiani v. Barber*, 261 F. 2d 709 (9th Cir. 1958), petition for certiorari dismissed, 358 U. S. 924; *Gonzales-Jimenez v. Del Guercio*, 253 F. 2d 420 (9th Cir. 1958); *Anderson v. Holton*, 242 F. 2d 596 (7th Cir. 1957); *United States ex rel. Kaloudis v. Shaughnessy*, 180 F. 2d 489 (2d Cir. 1950); *Batistic v. Pilliod*, 188 F. Supp. 344 (N. D. Ill. 1960), affirmed 286 F. 2d 268 (7th Cir. 1961), cert. den. 29 L. W. 3357, 3358; *United States ex rel. Trujillo-Gonzalez v. Esperdy*, 186 F. Supp. 909 (S. D. N.Y. 1906)]; *Civadelic v. Bouchard*, 185 F. Supp. 439 (D. C. New Jersey 1960); *Angelis v. Bouchard*, 181 F. Supp. 551 (D. C. New Jersey 1960)].

In *Cakmar v. Hoy, supra*, involving the exercise of discretion under Section 243(h) of the Immigration and Nationality Act, 66 Stat. 214, 8 U. S. C. A. §1253(h), this Court apparently limited the scope of review of such discretion to a determination “if procedural due process has been rendered the alien” [265 F. 2d at p. 62].

Also, in *MacKay v. McAlexander, supra*, involving an application for suspension of deportation under Section 244(a)(5) of the Immigration and Nationality Act, 66 Stat. 215, 8 U. S. C. A. §1254(a)(5), this Court declared (p. 40):



“\* \* \* But the granting of such relief to one eligible therefor is *an act of grace entrusted to the discretion of the Attorney General or his delegate*. Jay v. Boyd, 351 U. S. 345, 353, 76 S. Ct. 919, 100 L. Ed. 1242. Judicial review of the exercise of such discretion is *confined within extremely narrow limits*. See Cakmar v. Hoy, 9 Cir., 265 F. 2d 59.” (Emphasis added).

And in *Jay v. Boyd, supra*, the Supreme Court pointed out (p. 354):

“\* \* \* Although such aliens have been given a right to a discretionary determination on an application for suspension, cf. *Accardi v. Shaughnessy*, 347 U. S. 260, *a grant thereof is manifestly not a matter of right under any circumstances, but rather is in all cases a matter of grace*. Like probation or suspension of criminal sentence, it ‘comes as an act of grace,’ *Escoe v. Zerbst*, 295 U. S. 490, 492, and ‘cannot be demanded as a right,’ \* \* \*

**B. The Manner in Which Appellant’s Application Was Processed Was Fair, in Accordance With Law, and in Conformity With Procedural Due Process.**

**1. Appellant Was Not Entitled to a Hearing on His Application as Contemplated by the Administrative Procedure Act.**

Appellant seems to believe that his application required a determination “on the record after opportunity for an agency hearing” as provided for by Section 5 of the Administrative Procedure Act, 60 Stat. 239, 5 U. S. C. A. §1004 [Br. 8]. Appellee submits that such a hearing was not required. Neither Section 249

nor its regulation [8 C. F. R. 249.1, 23 F. R. 6545, 9124] require or provide for a hearing; consequently, Section 5 of the Administrative Procedure Act does not apply [*Weiss v. Esperdy*, .... F. Supp. .... (S. D. N. Y. March 7, 1961—not reported; Cf. *Cakmar v. Hoy*, 265 F. 2d 59 (9th Cir. 1958); *Namkung v. Boyd*, 226 F. 2d 385 (9th Cir. 1955); *Chiu But Hao v. Barber*, 222 F. 2d 821 (9th Cir. 1955), dismissed as moot 350 U. S. 870].

As this Court in *Cakmar v. Hoy*, *supra*, observed (p. 62):

“Appellants are not entitled to a hearing as of right before the Attorney General. The Attorney General can act, or not, as he likes. Section 1004 of the Administrative Procedure Act (5 U.S.C.A.) is not controlling. \* \* \*”

Appellant relies upon *United States ex rel. Paktorovics v. Murff*, 260 F. 2d 620 (2d Cir. 1958) [Br. 8, 11] for the proposition that the Constitution requires a hearing before parole can be revoked. That case, however, because of its peculiar facts, was *sui generis*, as the court was careful to point out [260 F. 2d at p. 613]. That a hearing is not required in the ordinary parole revocation case is demonstrated by the recent opinion in *Ahrens v. Masferrer Rojas*, .... F. 2d .... (5th Cir., June 30, 1961—not yet reported).

Since the regulation promulgated under Section 249 of the Immigration and Nationality Act [8 C. F. R. 249.1, 23 F. R. 6545] does not set forth a procedure for processing and deciding an application thereunder; appellant's application was processed in accordance with the general regulation in effect governing formal appli-

cations and petitions. The latter regulation [8 C. F. R. 103.2, 23 F. R. 9121] provided in part:

“\* \* \* The decision-rendering Service officer may, in his discretion, require the submission of additional evidence, including blood tests, may require the taking of testimony, and may direct the making of any necessary investigation\* \* \*”

In accordance with the regulation quoted above, appellant, while represented by counsel, was interrogated on December 10, 1958 by an immigrant inspector [Ex. 16 (T. 21-50)]. During this interrogation appellant presented as evidence a letter dated December 8, 1958 from an insurance agent [Ex. 16, p. 25 (T. 49-50); Ex. “A,” fourth document from end (T. 53)]. Appellant also presented as evidence a record of his wife’s birth [Ex. 21 (T. 51)], his marriage certificate [Ex. 22 (T. 52)], and the affidavits of two persons [Ex. “A,” documents second and third from end (T. 54-56)].

In his Brief [Br. 7] appellant urges that the “entire record relating to appellant’s application filed under the provisions of Section 249, *supra*, is fully set forth in the transcript of the record, pages 12-62, inclusive.” This is not true. The decisions of the District Director [Ex. 17 (T. 56-59)] and the Acting Regional Commissioner [Ex. 18 (T. 60-62)] reveal that they also considered the record of appellant’s deportation proceedings, and exhibits annexed thereto. Such consideration was in conformity with the regulation quoted above, as well as with procedural due process of law [Cf. *Namkung v. Boyd*, *supra*; *Chiu But Hao v. Barber*, *supra*].



**C. There Is Reasonable, Substantial, and Probative Evidence, if Required, to Support the Finding That Appellant Failed to Establish That He Is a Person of Good Moral Character.**

**1. *Reasonable, Substantial, and Probative Evidence Is Not Required.***

While the District Court concluded [Finding of Fact XIII, T. 13; Conclusion of Law IV, T. 14] that there is reasonable, substantial, and probative evidence to support the finding that plaintiff had failed to establish that he is a person of good moral character; we do not believe that such a standard is required. Rule 242(b)(4) of the Immigration and Nationality Act, 66 Stat. 210, 8 U. S. C. A. §1252(b)(4), providing that “no decision of deportability shall be valid unless it is based upon reasonable, substantial, and probative evidence,” is not applicable to appellant’s application under Section 249; since such application did not commence a proceeding to determine appellant’s deportability, but rather to determine whether discretionary relief from deportation should be granted. [*Cf. Chao-Ling Wang v. Pilliod*, 285 F. 2d 517, 519-520 (7th Cir. 1960)].

Equally inapplicable is the “substantial evidence” rule embodied in Section 10(e) of the Administrative Procedure Act, 60 Stat. 243-244, 5 U. S. C. A. §1009(e). Clause (5) of that subsection sets up the substantial evidence rule “in any case subject to the requirements of sections 7 or 8 or otherwise reviewed on the record of any agency hearing provided by statute.” As previously discussed [Part B 1, *supra*], Section 249 provides for no hearing, and proceedings thereunder are not subject to the requirements of Sections 7 or 8 of the Administration Procedure Act.

If the administrative authorities have failed to exercise discretion on an erroneous *legal* conclusion that eligibility has not been established, the courts will review the *legal* error and remand for exercise of discretion [*McGrath v. Kristensen*, 340 U. S. 162 (1950); *Desalernos v. Savoretti*, 356 U. S. 269 (1958)]. Where, however, the administrative conclusion of ineligibility is predicated on a *fact finding*, such as a failure to establish good moral character, the courts will not set aside the administrative decision unless it is arbitrary or capricious or an abuse of discretion [See, *Kam Ng v. Pilliod*, 279 F. 2d 207 (7th Cir. 1960), cert. den. 365 U. S. 860; *United States ex rel. Exarchou v. Murff*, 265 F. 2d 504 (2d Cir. 1959); *Fugiani v. Barber*, 261 F. 2d 709 (9th Cir. 1958); *Brownell v. Cohen*, 250 F. 2d 770 (Dist. Col. Cir. 1957)].

2. *If Required, the Record Contains Reasonable, Substantial, and Probative Evidence.*

At the outset it should be noted that the burden is upon the alien to prove that he is eligible for, and worthy of, a grant of discretionary relief [*Kimm v. Rosenberg*, 363 U. S. 405 (1960); *United States ex rel. Exarchou v. Murff*, 265 F. 2d 504 (2d Cir. 1959); *Brownell v. Cohen*, 250 F. 2d 770 (Dist. Col. Cir. 1957)].

Moreover, while substantial evidence requires “more than a mere scintilla” [*Consolidated Edison Co. v. N. L. R. B.*, 305 U. S. 197, 229 (1938)]; in determining whether substantial evidence exists, a court will not substitute its judgment for that of the immigration authorities [*Ocon v. Del Guercio*, 237 F. 2d 177, 180 (9th Cir. 1956); *United States v. Butterfield*, 223 F.

2d 804, 810-811 (6th Cir. 1955); *Taranto v. Haff*, 88 F. 2d 85, 86 (9th Cir. 1937); *Alexander v. Butterfield*, 150 F. Supp. 75, 78 (E. D. Mich. 1957); *In re Cartellone*, 148 F. Supp. 676, 681 (N. D. Ohio, 1957), affirmed *sub nom Cartellone v. Lehmann*, 255 F. 2d 101 (6th Cir. 1958), cert. den. 358 U. S. 867); nor will a court weigh the evidence (*Lattig v. Pilliod*, 289 F. 2d 478 (7th Cir. 1961)].

During 1929 appellant executed a Preliminary Form for Declaration of Intention to Become a Citizen [Ex. 10; R. 17]. On this form appellant stated, *inter alia*, that he entered the United States under the name of Carlo Di Nello on January 15, 1923, that he arrived on the Conte Rosso as a passenger, that he traveled on an immigration visa, and that he was examined by immigration officers at New York [Ex. 10]. This information was false, since appellant now admits that he entered the United States as a stowaway, without inspection, and without a passport, visa, or other entry document [Ex. 16, p. 3 (T. 23); R. 4, 8]. On the basis of this false information appellant was able to file a Declaration of Intention [Ex. 8] with the United States District Court at Los Angeles, California, and to be issued a copy thereof [R. 16]; since another person by the name of Carlo Di Nello had in fact lawfully entered the United States on the vessel and at the date and place claimed by appellant [Ex. 9; See also Exs. 11, 12, and 13].<sup>6</sup> The Declaration of Intention [Ex. 8],

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<sup>6</sup>The real Carlo Di Nello had first entered the United States on June 20, 1916 [Ex. 11], returned to Italy during 1922 [Ex. 13], and reentered the United States on January 15, 1923 [Exs. 9 and 13]. The manner in which appellant obtained data pertaining to the re-entry of the real Carlo Di Nello remains a mystery [Ex. 13].



which appellant executed under oath, also contained false information.

On his Alien Registration Form, which was executed under oath on December 16, 1940 [Ex. 2] and on his 1957 and 1958 Address Report Cards [Exs. 6 and 7] appellant repeated portions of the data relating to his claimed entry on January 15, 1923; claiming on his Alien Registration Form to have entered the United States as a "Passenger" (rather than as a "Stowaway") [Ex. 2, item 7(c)] and as a "Permanent Resident" [Ex. 2, item 7(d)]; and claiming on both his 1957 and 1958 Address Report Cards to be in the United States as a Permanent Resident [Exs. 6 and 7].<sup>7</sup>

Appellee submits that these false statements alone constitute substantial evidence that appellant failed to establish that he was a person of good moral character [Cf. *Gonzales-Jamenez v. Del Guercio*, 253 F. 2d 420 (9th Cir. 1958)]. Under the Immigration and Nationality Act of 1952<sup>8</sup> "one who has given false testi-

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<sup>7</sup>Appellant also gave false information on his Alien Registration Form [Ex. 2, item 9] and on his Application for Certificate of Identification [Ex. 3, item 4] concerning his employment; since appellant now admits that he has not been employed since 1936 or 1937 [Ex. 16, p. 7 (T. 29)].

<sup>8</sup>Section 101(f) of the Immigration and Nationality Act, 66 Stat. 172, 8 U. S. C. A. §1101(f) provides in part:

"(f) For the purposes of this Act—

"No person shall be regarded as, or found to be, a person of good moral character who, during the period for which good moral character is required to be established, is, or was—

\* \* \* \* \*

(5) one who has been convicted of two or more gambling offenses committed during such period;

(6) one who has given false testimony for the purpose of obtaining any benefits under this Act;"

\* \* \* \* \*

"The fact that any person is not within any of the foregoing classes shall not preclude a finding that for other reasons such person is or was not of good moral character."

mony for the purpose of obtaining any benefits under” the Act is absolutely barred from establishing good moral character [*Buffalino v. Holland*, 277 F. 2d 270, 276-278 (3d Cir. 1960), cert. den. 364 U. S. 863]; and this provision has been applied to an alien who filed a false statement in naturalization proceedings [*Orlando v. Robinson*, 262 F. 2d 850 (7th Cir. 1959); but compare *Sharaiha v. Hoy*, 169 F. Supp. 598 (S. D. Calif. 1959)]. While the absolute bar of the 1952 Act may not be applicable to appellant’s false claims,<sup>9</sup> it is indicative of the seriousness of such claims and of current congressional policy towards them [See, *Hintopoulos v. Shaughnessy*, 353 U. S. 72, 78 (1957)]. We submit, therefore, that these false claims alone constitute substantial evidence that appellant failed to establish that he was a person of good moral character; especially since appellant continued to conceal his illegal entry into the United States until its disclosure was compelled. As the Court in *Orlando v. Robinson*, *supra*, tersely remarked (p. 851):

“\* \* \* At the risk of being labeled prosaic we do not classify a prevaricator as a person of good moral character. Certainly mendacity is not a virtue.”

In addition, under the Immigration and Nationality Act of 1952 “one who has been convicted of two or more gambling offenses committed” during the period

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<sup>9</sup>See, however, *In re Naturalization of K*, 174 Fed. Supp. 343 (D. C. Md. 1959), where the court remarked (p. 344):

“\* \* \* In view of the difference in wording between the various numbered paragraphs of sec. 101(f), it may be that such false testimony, whenever given, would be an absolute bar. \* \* \*” (Emphasis added.)

for which good moral character is required to be established is absolutely precluded from establishing good moral character [See Section 101(f)(5), quoted in footnote 8, *supra*; *In re Lee Wee's Petition*, 143 F. Supp. 736 (S.D. Calif. 1956)]. Appellant has been convicted of at least four, and perhaps five, gambling offenses.<sup>10</sup> Here, again, while the absolute bar of the 1952 Act may not be applicable to appellant's convictions, it is indicative of Congressional policy towards gambling offenses as they relate to good moral character. Thus, appellant's repeated convictions of gambling offenses over a span of more than two decades militate strongly against his good moral character. As the Court in *In re Naturalization of K*, 174 F. Supp. 343 (D. C. Md. 1959), observed (p. 345):

“\* \* \* good moral character is not a momentary attribute; *evidence of past misconduct though it may not be a bar if the applicant has in fact reformed, should be received and considered along with other evidence* in determining whether a petitioner has shown good moral character at the time of his or her application.”

See also:

*In re Siacco's Petition*, 184 F. Supp. 803 (D. C. Md. 1960).

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<sup>10</sup>On his Application to Create Record of Admission for Permanent Residence appellant admitted conviction of a gambling offense during each of the years 1928, 1929, 1930, 1945, and 1951 [Ex. 15, item 23 (T. 18)]. The records of the Municipal Court, however, apparently show the 1928 gambling charge as having been dismissed [Ex. 17 (T. 58)]. In addition, appellant was convicted on or about March 27, 1931 for failure to report a gunshot wound and to summon aid. Appellant claimed not to remember this incident, but admitted that “it must be correct” [Ex. 16, p. 13 (T. 36-37)].



Moreover, for at least three years immediately preceding his marriage, appellant cohabited with his present spouse as man and wife [Ex. 16, p. 16 (Tr. 40)]. During this period no impediment to appellant's marrying existed.<sup>11</sup> Appellant married on July 27, 1958 [Ex. 22 (T. 52)], after an order of deportation had been entered against him by a special inquiry officer, *and after the Board of Immigration Appeals had rendered its decision of July 2, 1958 directing that the case be remanded to the Special Inquiry Officer for the purpose of permitting appellant to file an application for a record of lawful admission* [See decision in Ex. "A"].

We submit that appellant's extra-marital relationship prior to his marriage militates against his good moral character. In *Estrada-Ojeda v. Del Guercio*, 252 F. 2d 904 (9th Cir. 1958) this Court held that an extra-marital relationship alone was sufficient to support the finding that an alien "had not proved that she then was and had been a person of good moral character" (p. 905).

Appellant relies upon *Posusta v. United States*, 285 F. 2d 533 (2d Cir. 1960) [Br. 12]. That case holds "no more than that even a continued illicit relation is *not inevitably* an index of a bad 'moral character.'" (p. 535—emphasis added). In the *Posusta* case the court noted that there were "greatly extenuating circumstances" (p. 535).

We submit, therefore, that appellant's false claims, his conviction for gambling offenses, and his extra-

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<sup>11</sup>Appellant's claim that he did not marry earlier because he was sick is refuted by his statement that he is still sick and that he is always going to be sick [Ex. 16, p. 16 (T. 40-41)].

marital relationship, when considered together, clearly constitute reasonable, substantial, and probative evidence that appellant failed to establish that he was a person of good moral character (indeed, each alone is probably sufficient); without considering his attendance at the meeting at Appalachin, New York, in November, 1957 and his association with many persons publicly known to have police records [Ex. 16, pp. 17-23 (T. 41-48); R. 19-22]. Appellant, while discussing such attendance and associations in his brief [Br. 9-12] seems to forget that the burden rested upon him to prove that he was eligible for, and worthy of, his requested grant of discretionary relief [*Kimn v. Rosenberg, supra*; *United States ex rel. Exarchou v. Murff, supra*; *Brownell v. Cohen, supra*].

**D. The Denial of Appellant's Application in the Exercise of Discretion by the Acting Regional Commissioner Was Neither Arbitrary nor Capricious nor an Abuse of Discretion.**

Good moral character is merely one of the statutory prerequisites to the exercise of discretion under Section 249 of the Immigration and Nationality Act [See, *Lum Chong v. Esperdy*, 191 F. Supp. 935 (S. D. N.Y. 1961); *Sit Jay Sing v. Nice*, 182 F. Supp. 292 (N. D. Calif. 1960)]; and does not demand its favorable exercise: (Cf. *Hintopoulos v. Shaughnessy*, 353 U. S. 72 (1957); *Jay v. Boyd*, 351 U. S. 345, 349-350 (1956); *MacKay v. McAlexander*, 268 F. 2d 35 (9th Cir. 1959), cert. den. 362 U. S. 961; *Clair v. Barber*, 258 F. 2d 558 (9th Cir. 1958); *Barreiro v. Brownell*, 215 F. 2d 585 (9th Cir. 1954), cert. den. 348 U. S. 887; *United States ex rel. Kaloudis v. Shaughnessy*, 180 F. 2d 489 (2d Cir. 1950)].

As the Supreme Court in *Jay v. Boyd, supra*, pointed out (p. 353):

“Eligibility for the relief here involved is governed by specific statutory standards which provide a right to a ruling on an applicant’s eligibility. However, Congress did not provide statutory standards for determining who, among qualified applicants for suspension, should receive the ultimate relief. *That determination is left to the sound discretion of the Attorney General.*” (Emphasis added).

The Acting Regional Commissioner not only found in his decision that appellant had failed to sustain the burden of proof which is upon him of establishing that he is a person of good moral character, but went further and denied the application “*in the exercise of the discretion conferred by Section 249 of the Immigration and Nationality Act*” [Ex. 18 (T. 60-63)]. In so doing, the Acting Regional Commissioner did not act in an arbitrary or capricious manner, but gave sound reasons for his unfavorable exercise of discretion [Ex. 18, second page (T. 61-62)], including the fact that appellant has had “*no real substantial visible means of support since 1936*” [Ex. 18 (T. 62)—emphasis added; see also Ex. 16, pp. 6-15 (T. 28-36)].

Undoubtedly appellant’s attendance at the Appalachian meeting and his lack of candor in stating the circumstances of his attendance were factors in the discretionary denial of his application under Section 249 [Ex. 18, second page (T. 61-62)]. In this regard, appellant refers to (without citing) *United States v. Buffalino*, 285 F. 2d 408 (2d Cir. 1960), which reversed the crim-



inal conviction of persons attending the Appalachin meeting [Br. 10]. Of course, appellant's acquittal in the criminal case is not *res judicata* in his administrative proceedings under Section 249 [*Helvering v. Mitchell*, 303 U. S. 391 (1938); *Lewis v. Frick*, 233 U. S. 291 (1914)]; and, needless to say, there is a vast difference between a criminal prosecution, in which the Government must prove its case beyond a reasonable doubt, and a proceeding in which an alien, admittedly deportable, seeks the grant of discretionary relief. The relief which appellant sought by his application under Section 249

“\* \* \* is not given to deportable aliens as a right, but, by congressional direction, it is dispensed according to the unfettered discretion of the Attorney General.” [*Jay v. Boyd*, 351 U. S. 345, 357-358 (1956)].

### Conclusion.

Wherefore, for the reasons set forth above, it is respectfully submitted that the judgment of the District Court in favor of appellee, denying the relief prayed for in appellant's Complaint, should be affirmed.

Respectfully submitted

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No. 17350 ✓

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

DAVID FARRELL, *et al.*,

*Appellants,*

*vs.*

GEORGE E. DANIELSON, *et al.*,

*Appellees.*

---

## APPELLEES' REPLY BRIEF.

---

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No. 17350

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---

## APPELLEES' REPLY BRIEF.

---

### POINT I.

#### THE APPELLANT CONSENTED TO THE ENTRY OF THE PRELIMINARY INJUNCTION.

#### Argument.

By an Order of this Court, there has been filed for consideration, a transcript of the proceedings held in the United States District Court before the District Judge on January 30, 1961. The transcript on file contains a number of matters. The question of the issuance of a preliminary injunction commences on page 39 at line 8 and continues through and including page 46, line 7.

A reading of the exchange between the Court and counsel indicates quite clearly that counsel for the Appellants consented to the issuance of a preliminary injunction in order to maintain the *status quo* of the pro-



ceedings pending a trial and pending the substitution of Trustees in Bankruptcy. [Page 44, line 12.]

“Mr. Cuthbertson: There was no hearing on that at any time. No hearing on the temporary restraining order. It was issued *ex parte*. However, we are perfectly willing that a restraining Order issue.” [Page 44, line 24.]

“Mr. Cuthbertson: We have no objection to being restrained in that connection. Mr. Farrell has no intention of running away with it.” [Page 46, line 3.]

The Court: And a temporary injunction will be issued pending that restraining the defendant from selling the airplane.

Mr. Young: “I will prepare Findings of Fact and serve it on counsel and submit it to your Honor.”

In view of the exchange taken from the record of the Court and in view of the positive assertion of counsel for the Appellants regarding the consent to the issuance of a preliminary injunction it would appear to the undersigned that many of the arguments and statements of counsel contained in the opening Brief are somewhat pallid.

This is true, as well, of the statements of counsel for Appellant regarding the deposition of David Farrell wherein he states in his Brief that the deposition was never offered, never read into the record not considered by the trial Judge in the making of the Find-

ings of Fact, Conclusions of Law and Preliminary injunction.

The transcript, page 41, line 2:

Mr. Young: "So at this time, I wish to make an Order for the continuation of the Order pendente lite for the preliminary injunction and do now offer into evidence a transcript of the testimony of David Farrell which is in the hands, I believe of the Clerk and which we had at the last hearing and asked that it be received in evidence. And based upon that evidence, I asked the Court for permission to draw Findings of Fact in harmony with the evidence shown so that we may get a preliminary injunction based upon Findings of Fact to continue in effect the injunction that we have so that our successor in interest, the Referee in Bankruptcy, the Trustee in Bankruptcy will be fully protected against any of these transfers."

The Court: "Is there any objection to this method of maintaining the status quo which has to be maintained and which will leave everybody in a position of asserting the same rights in the Bankruptcy Court with the review by me sitting as a District Judge?" (No objection voiced by Mr. Cuthbertson).

**POINT II.**

**AN INJUNCTION IS ISSUED TO PREVENT PROBABLE DAMAGE TO A PLAINTIFF IN AN ACTION PENDING THE OUTCOME OF A TRIAL ON THE MERITS INVOLVING THE ENTIRE CONTROVERSY.**

**Argument.**

An injunction is recognized as an unusual device and one which inheres in a court of equity or any court for that matter in order to protect the litigants from loss, damage or the destruction of a right pending a determination of the controversy in chief.

An injunction of a preliminary type is frequently issued to maintain the *status quo*. Such is the type of injunction which was issued in this case. It is normally issued by the Court when the damages or loss to the plaintiff far exceed or outweigh the damage or loss to the defendant which might result or accrue in the event such an injunction were not to be issued.

*Ross Whitney Co. v. Smith Kline & French Laboratory* (C. A. 9, 1953), 207 F. 2d 190.

**POINT III.**

**THE ISSUANCE OF AN INJUNCTION IS ENTIRELY DISCRETIONARY WITH THE TRIAL JUDGE.**

**Argument.**

No argument is necessary on this point. It is a recognized principle of law surrounding the issuance of preliminary injunctions.

See the case of

*Lane Bryant v. Maternity Lane* (C. A. 9, 1949),  
173 F. 2d 559.



POINT IV.

THE FINDINGS OF FACT RECITED BY THE DISTRICT JUDGE ARE NOT TO BE REVERSED OR UPSET UNLESS THEY ARE "CLEARLY ERRONEOUS".

Argument.

While the rules of procedure require the making of Findings of Fact and Conclusions of law in connection with the issuance of a preliminary injunction, the scope of appeal is the same as any other appeal wherein the Findings of Fact are to be reviewed. In the making of preliminary injunctions however, sometimes affidavits are considered or other somewhat less formal methods of proof. The Findings themselves are of a preliminary nature, their only significance is to support the preliminary injunction made. In the case at Bar, the deposition of David Farrell was filed with the Clerk and by consent was considered as the evidence which would have been introduced at the cause in support of the injunction. The Findings of Fact and Conclusion made are clearly supported by a reading of the deposition of David Farrell. The Findings made by the Judge may be made as a result of direct or inferential evidence and are not to be reversed unless such Findings are within the rule as being clearly erroneous.

*Champion Spark Plug Co. v. Reich* (C.C.A. 8, 1941), 121 F. 2d 769. Certiorari denied 314 U. S. 669.

POINT V.

ON APPEAL OR ON REVIEW OF AN ORDER RELATING TO A PRELIMINARY INJUNCTION, THE APPELLATE COURT WILL GO NO FURTHER THAN NECESSARY TO DISPOSE OF THE APPEAL.

*Ross Whitney Corporation v. Smith, Kline & French Lab. supra.*

POINT VI.

The other points covered by counsel in his Brief regarding a violation of Rule 65 of the Federal Rules of Civil Procedure are within the framework of the Rule of harmless error. Deviation from proper procedure in connection with the issuance of the decree or a preliminary injunction which are non-prejudicial in nature, do not constitute grounds for reversal.

*Swift v. Black Panther Oil Co.* (C. A. 8, 1917),  
244 Fed. 20;

*In re Lustron Corporation* (C. A. 7, 1950), 184  
F. 2d 789, certiorari denied 340 U. S. 946; etc.

The Findings, conclusions and decree follow the language of the complaint. Since counsel consented he may not now object.

It is respectfully submitted that the Preliminary Injunction was properly issued and the appeal should be denied with costs to the Appellee.

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GENDEL & RASKOFF,  
BURKE MATHES,

*Attorneys for Appellees George E.  
Danielson, James A. Smith, Stanley A. Phips, Trustees in Bankruptcy.*

---

**In the United States Court of Appeals  
for the Ninth Circuit**

---

**NATIONAL LABOR RELATIONS BOARD, PETITIONER**

*vs.*

**UNITED ASSOCIATION OF JOURNEYMEN AND APPRENTICES  
OF THE PLUMBING AND PIPEFITTING INDUSTRY OF THE  
UNITED STATES AND CANADA, LOCAL 469, AFL-CIO,  
ET AL., RESPONDENTS**

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**On Petition for Enforcement of an Order of  
The National Labor Relations Board**

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**BRIEF FOR THE RESPONDENTS**

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**FILED**

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**JAN - 2 1962**

**FRANK H. SCHMID, CLERK**

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 17451

NATIONAL LABOR RELATIONS BOARD, PETITIONER

*vs.*

UNITED ASSOCIATION OF JOURNEYMEN AND APPRENTICES  
OF THE PLUMBING AND PIPEFITTING INDUSTRY OF THE  
UNITED STATES AND CANADA, LOCAL 469, AFL-CIO,  
ET AL., RESPONDENTS

---

**On Petition for Enforcement of an Order of  
The National Labor Relations Board**

---

**BRIEF FOR THE RESPONDENTS**

---

**STATEMENT OF FACTS**

**I.**

**The strike against Thomas — stated generally.**

Thomas was engaged as a general contractor in constructing a telephone building at Winslow, Arizona. (R. 4) He employed one carpenter and two or three laborers. These employees were represented respectively by respondents Carpenters Local 1100 and Laborers Local 556 (R. 5; General Counsel's Exhibit No. 2, R. 105, 106).

Thomas had no plumbing employees. He subcontracted the plumbing work on the telephone building

to Howard Johnson, a non-union plumbing contractor from Phoenix, Arizona. (R. 5, 118)

Thomas commenced work on the building on September 8, 1959, (R. 46) and continued thereafter during all times material herein. Johnson's plumbing employees began work on October 12th (R. 5) when they installed two area drains on that day and on the next day, October 13th. (R. 136) They were next scheduled to return to the job site on the following Monday, October 19th. (R. 127)

On October 15th, when the plumbing employees were not on the job, respondents Carpenters Local 1100 and Laborers Local 556 directed, respectively, the one carpenter and three laborers not to return to work on Friday, October 16th. (R. 8, 10)

Because of the resulting work stoppage, Johnson immediately charged that the respondents had engaged in a secondary boycott, (R. 127) raising the issue whether respondents caused the employees of Thomas to strike with an object of forcing Thomas to cease doing business with Johnson.

## II.

### Particular facts of strike.

On Thursday, October 15th, Thomas' building superintendent, a man named Tacke, returned to the job site after having been absent about forty minutes. Waiting for him were four business agents: Wright, representing Laborers Local 556; Kropp, representing Carpenters Local 1100; Martin, a business agent of respondent Local 469; and a man named Logan who apparently was a representative from the Teamsters union. (R. 53, 54) A conversation then occurred be-

tween the business agents and Tacke lasting for about half an hour. (R. 56) During the course of this conversation, two items were mentioned or discussed: 1) the fact that the plumbing was being done by Howard Johnson; and, 2) that Thomas had in his employ a night watchman who was not receiving the wage scale called for in the laborers collective bargaining agreement.

Wright asked Tacke who had done his plumbing and Tacke said, "Howard Johnson." (R. 54) This was all that was said on this matter.

The night watchman matter was discussed in two respects: 1) whether he was a night watchman or a guard, and 2) whether, if he was a night watchman, he was being paid the union scale. Martin asked the name of the night watchman and how much he was getting paid. He said something about the night watchman not being paid enough and that he wasn't dispatched from the union hall. (R. 55) Wright inquired about the status of the night watchman, that is, whether he carried a pistol, had a deputy sheriff's badge. (R. 65) Tacke didn't know whether the night watchman was supposed to be union or not. (R. 71) Wright was figuring on the top of a box regarding the night watchman's pay, and concluded that the night watchman was getting less than \$1.50 per hour, (R. 70) "a little bit below the union scale." (R. 65)

At some point in the conversation Wright said, "Well, I am going to have to pull our boys off. However, I will let you finish pouring your concrete." (R. 54)

Immediately thereafter, Kropp spoke with the carpenter employee (R. 83) and Wright talked to the la-



borers. (R. 85) None of these employees reported to work the following day.

## ARGUMENT

### I.

**There was no substantial evidence that Respondents had as an object of the strike the forcing of Thomas to cease doing business with Johnson.**

Prior to October 15th, on numerous occasions, various business agents from various construction unions in varying combinations, visited the job site. (R. 47) Martin, from the plumbers union, was present at most but not all of these visits. (R. 52) When Tacke advised in September that Johnson was to do the plumbing, Martin is reported to have said that "he won't do." (R. 50) These prior remarks, coupled with the fact that Johnson was mentioned in the October 15th conversation, constituted the basis of the trial examiner's opinion that the respondents engaged in a secondary boycott. This is reflected in the Intermediate Report: (R. 21)

" . . . It appears clear to me that there is nothing here to overcome or balance all reasonable inferences to be drawn from Tacke's conversations with union business agents on October 15 and prior to that date in which they stated in effect that a sub-letting of the plumbing work to Johnson would not do because he was non-union, and Wright's statement on October 15, after learning some plumbing had actually been done by Johnson employees, that he was 'going to have to pull our boys off . . . ' "

This is the basic finding. It is subject to considerable question. It ignores many facts disclosed by the evidence which are at odds with it.

First, the conversation on October 15th between the business agents and Tacke, Thomas' superintendent,

was essentially taken up with a discussion of the night watchman problem and not with Johnson. (R. 55, 56, 65, 66, 70, 71) When and at what point, and for what *particular* reason, Wright stated that he'd have to "pull our boys"—all these questions are left to conjecture. The trial examiner, himself, has supplied the "evidence" to clarify this situation, however, by finding that it was made immediately and in response to Tacke's advice that Johnson was doing the plumbing. Note that the trial examiner supplies the word, "Thereupon", to his finding on this point. (R. 18) It is not in Tacke's testimony.

Second, it ignores the fact that nothing *new* relative to Johnson was told to the business agents by Tacke in the October 15th conversation. They had known for a *month* that Johnson had the subcontract to do the plumbing. (R. 48-50) On the other hand, the violation of the agreement regarding the night watchman first came to light in this October 15th meeting.

Third, the trial examiner seems to have over-looked the fact that the plumbers were not then on the job; that the plumbers returned to work the following Monday, the 19th, as per schedule and worked alongside the carpenter and laborers without any difficulty, (R. 141, 142) the same as they had on October 12th and 13th; that the plumbers returned to work again on October 26th and continued to work on the job without there ever being any trouble or question raised. (R. 113, 114, 128)

Fourth, the trial examiner ignored the fact that the business agents, without the plumbers' business agent being present, met with Thomas on the Monday following the work stoppage, at which time the business agents made no mention of Johnson or the plumbers,



referring only to their grievance concerning the failure of Thomas to pay union scale to the night watchman; that the only mention of Johnson made at that meeting was at the end thereof when *Thomas* brought up the subject, to which the business agents made no response. (102, 103, 120)

Fifth, the trial examiner ignored the fact that the night watchman was given an immediate raise, as of Monday, the 19th, to the extent of \$44.00 per week, as a result of the Monday meeting in Flagstaff between Thomas and the business agents. (R. 76)

On the other hand, the trial examiner obviously gave considerable weight to the sheerest kind of hearsay involving discussions and conversations between persons outside the presence of respondents. Notwithstanding respondents' continuing objection to this sort of testimony, it is quite clear that the trial examiner relied on the *truth* of statements made by *Tacke* to certain plumbing employees to the effect that *Thomas* "had agreed to keep the plumbers off the job until things were settled." (R. 19, 61)

The trial examiner exhibited an interesting approach to "discrediting" witnesses. He implies that Thomas was testifying favorably to the union, and "trying to state nothing more injurious . . . than was required of him. . . ." (R. 20) The trial examiner then goes on in this context to give credence to the truth of hearsay statements made by *Thomas* to *Tacke* to the effect that Kropp had said to Thomas on Saturday morning, by telephone, that the carpenters would go back on the job "providing there were no plumbers on the job." (R. 20, 21, 58) Thus, hearsay was given the impact of truth even though Thomas in his testimony could not recall any such conversation with Kropp. (R. 102)



Where is the evidence, properly admitted, that substantiates the trial examiner's conclusion that an object of the strike was to force Thomas to cease doing business with Johnson? In this connection, it must be remembered that the "object" had to be an *immediate* or *direct* object, if it was to be labeled unlawful. *NLRB v. Bangor Building Trades Council*, (CA-1; 1960) 278 F. 2d 287.

The strike in this case was *primary* in nature, lawfully calculated to remedy the violation by Thomas of the bargaining agreement. Essentially all the evidence points to this. In such a situation, the "an object" test, *NLRB v. Denver Building and Construction Trades Council*, 341 U. S. 675, becomes too narrow. In *Local 618, Automotive, Petroleum, etc. Union v. NLRB*, (CA-8; 1957) 249 F. 2d 332, 33 Labor Cases No. 71,081, the court said:

"We believe that . . . where lawful picketing in support of a valid primary strike is in progress against the primary employer at the employer's premises, the 'an object' test . . . is too narrow, and that there should be evidentiary support for a conclusion that the primary picketing serves no lawful purpose. . . ."

The trial examiner avoided making a clear finding on whether the respondents had a primary right involved. However, by implication, he suggests that this matter of the night watchman was but an *afterthought*. (R. 20) Yet, the evidence shows without dispute that Wright told Tacke *immediately before* the strike that Thomas was paying below scale. (R. 65)

It seems entirely reasonable that the respondents may have been happy to have a legitimate reason to strike Thomas, but that happiness is not enough to make

their primary strike into a secondary boycott. Assuming a "residual hope that a prohibited end" would be realized by striking Thomas, yet, this would not condemn the permissible objective of rectifying the contract violation regarding the wages of the night watchman. *Local 618 v. NLRB, supra*; *NLRB v. Local 50, Bakery and Confectionery Workers*, (CA-2; 1957) 245 F. 2d, 542, 32 Labor Cases No. 70,726.

Respondents respectfully submit that there is no substantial evidence supporting the decision of the trial examiner, nor the Board decision adopting it, insofar as it concludes that respondents engaged in a secondary boycott against Thomas with a direct or immediate object of forcing him to cease doing business with Johnson.

## II.

### **The Amended Order is too broad in scope.**

In its original Order, dated September 12, 1960, the Board ordered respondents to cease and desist from engaging in, or inducing or encouraging the employees of W. D. Don Thomas Construction Company, etc. where an object thereof was to force Thomas to cease doing business with Johnson. (R. 13) The General Counsel, on October 4, 1960, moved for reconsideration, urging a broader order. On March 10, 1961, the Board issued its Amended Order, broadening its order to include not only Thomas but "any other employer" "or person".

Assuming that respondents engaged in a secondary boycott, this Amended Order is too broad in scope and is not supported by substantial evidence in view of the record as a whole, and in view of the evidence as specifically found by the Board.



One of the respondents had had some contract difficulty with Johnson in past years, when he was a union contractor, but in each instance the conduct was lawful. No dispute about this. Johnson had finally ceased to be signatory to a labor agreement in 1957. (R. 129-131, 135) Since then he had subcontracted without trouble on numerous jobs where union people worked. (R. 133, 134)

There were no findings made by the trial examiner or Board regarding this matter.

The authority conferred upon the Board is to restrain the unlawful practice which it has found to have been committed. It does not have authority, however, to restrain generally all other unlawful practices which might occur, and which are not found to be persuasively related to the proven unlawful conduct. *Communications Workers of America, AFL-CIO and Local 4372 v. National Labor Relations Board*, 362 U. S. 479, 40 Labor Cases No. 66,461; *National Labor Relations Board v. International Longshoremen's Union, Local 10*, (CA-9; 1960) 283 F. 2d 558, 41 Labor Cases No. 16,591; *National Labor Relations Board v. Local Union 751, United Brotherhood of Carpenters*, (CA-9; 1960) 285 F. 2d 633, 41 Labor Cases No. 16,716; *National Labor Relations Board v. Ochoa Fertilizer Corporation*, (CA-1; 1960) 283 F. 2d 26, 41 Labor Cases No. 16,587; and *United Steelworkers of America v. National Labor Relations Board*, (CA-D. C.; 1961) 294 F. 2d 256, 42 Labor Cases No. 16,929.

In *National Labor Relations Board v. International Longshoremen's Union, Local 10*, supra, this Circuit Court made the following observation:



“The Board cannot restrain practices which it has neither found to be pursued nor to be related to proven unlawful conduct. *Communications Workers*, . . . . See also *Morrison-Knudsen Co. v. NLRB*, 276 F. 2d 63, 76, 39 Labor Cases No. 66,308 (Ninth Circuit, 1960). A broad order will be modified unless the evidence supports a *proclivity* for unlawful action or unless a finding relating to the *likelihood of similar violations is made*. . . .” (Emphasis Added)

In the instant case the evidence does not show a proclivity for <sup>un</sup>lawful action on the part of these respondents, nor does it show a likelihood of similar violation against other employers.

Petitioner has attempted to distinguish the instant case from the rule laid down in *Communications Workers* and would have this Court follow an earlier Supreme Court decision, *International Brotherhood of Electrical Workers v. National Labor Relations Board*, 341 U. S. 694. Respondents are uninformed whether a similar argument has been made to this Court before. However, the report of the *Ochoa* Case shows that *International Brotherhood of Electrical Workers* was there considered. Nonetheless, *Ochoa* relied upon the more recent *Communications Workers*:

“ . . . where the Court held virtually without discussion, that because there was no evidence of a ‘generalized scheme’ a union’s interference with the employees of one particular employer could not justify a decree against activity with relation to the employees ‘of any other employer’. . . .”

The respondents respectfully submit that the Amended Order is unwarranted and that it should be modified by omitting from Paragraph 1 thereof (R. 31)

the following phrases: "or other employer" and "or any other employer or person."

### CONCLUSION

Respondents respectfully urge that the Board's Decision and Supplemental Decision are not supported by substantial evidence. Further Respondents urge that the Amended Order, even if Respondents did commit an unfair labor practice, is too broad in scope.

Respectfully submitted,

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*Attorney for Respondents.*

December 29, 1961





No. 17,352 ✓

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

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FARMERS UNION CORPORATION,  
*Petitioner,*

VS.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

On Petition for Review of the Decision of the  
Tax Court of the United States

**BRIEF FOR PETITIONER**

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FILED

SEP 17 1961

JOHN H. SCHMID, CLERK



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**On Petition for Review of the Decision of the  
Tax Court of the United States**

**BRIEF FOR PETITIONER**

---

**JURISDICTIONAL STATEMENT**

This is a petition to review a decision of the Tax Court of the United States.

The petitioner is a corporation, organized under the laws of the State of California, on May 19, 1874. Its only business location is at 151 West Santa Clara Street, San Jose, California. The income tax returns involved in the subject controversy (calendar years 1951, 1952 and 1953) were filed with the District Director of Internal Revenue for the First District of California, at San Francisco, California. The hearing before the Tax Court of the United States was held

in San Francisco on October 7, and October 14, 1958. The proceedings were held pursuant to a statutory (90 day) letter, issued June 20, 1957, by the Commissioner of Internal Revenue for the Revenue District that includes the State of California (R. 3), a petition for redetermination of the alleged income tax deficiencies was filed with the Tax Court of the United States on September 3, 1957 (R. 5-8), and was answered by the Commissioner of Internal Revenue on October 16, 1957. (R. 8-9.) An Amendment to the Answer of the Commissioner was filed September 16, 1958 and petitioner's Reply to Amendment to Answer was filed at trial October 7, 1958. (R. 10-11.)

The Tax Court Memorandum (1960-179) containing its findings of fact and opinion was filed August 31, 1960 (R. 4, 254) and the Decision under Rule 50 of the Court was entered October 25, 1960. (R. 299.) The petition for review was filed January 19, 1961. (R. 300-302.)

The Tax Court of the United States had jurisdiction under 26 U.S.C. 7442. The United States Court of Appeals for the Ninth Circuit has jurisdiction under 26 U.S.C. 7482, 7483 (Internal Revenue Code of 1954, Section 7482).

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### STATEMENT OF THE CASE

This case involves income tax deficiencies alleged by the Commissioner of Internal Revenue and determined by the Tax Court to be in the amounts of \$22,309.36 for 1951; \$4,800.95 for 1952; and \$7,647.91 for 1953 (calendar years).



The controversy as to all three years emanated from a loss incurred by petitioner, on June 30, 1951, when it transferred the inventory and related assets constituting its retail hardware business to seven stockholders in exchange for 8,000 shares of the 20,000 outstanding shares of its capital stock. Subsequent to this transaction these stockholders formed a partnership. Petitioner reported this loss in its income tax return for 1951 by including the agreed market value of stock received in the exchange as gross sales and noting the closing inventory as zero. The cost of goods sold thereby exceeded the gross sales by \$217,527.20. (R. 275.) Respondent disallowed the reported loss and recomputed petitioner's income, after adding the cost of the inventory exchanged for stock to gross income. This disallowance was based upon respondent's contention that the transfer of corporation property for its capital stock was not a taxable exchange but a non-taxable distribution in partial liquidation.

The alleged income tax deficiencies for 1952 and 1953 are based on (1) respondent's disallowance of a carryover of a portion of the loss reported in 1951 to offset income of petitioner in the succeeding years, and (2) disallowance by respondent of deductions claimed by petitioner for accounting, legal and escrow expenses incurred and paid in connection with the exchange transaction described herein.

The issues are:

A. Whether the transfer by petitioner of its mercantile inventory and related assets and liabilities in exchange for 8,000 shares of its outstanding capital

stock was a taxable transaction or a non-taxable distribution of corporate assets in kind in partial liquidation.

B. Whether the loss sustained by petitioner in the exchange of corporation property for stock was a net operating loss, the unused portion of which was available to offset income in the five years succeeding 1951 or just a "non-business" loss that must be confined to that year for tax purposes.

C. Whether the legal, accounting and escrow expenses incurred and paid by petitioner in the subject transaction were deductible business expenses or capital expenditures of the new partnership entity that was formed by the stockholders who acquired the mercantile inventory from petitioner.

---

**SPECIFICATION OF ERRORS RELIED ON  
BY PETITIONER**

1. The Tax Court erred in holding that the transfer of corporation property in exchange for capital stock of the transferor (petitioner) was a distribution in partial liquidation in which no gain or loss may be recognized for income tax purposes.

2. The Tax Court erred in holding that if it be assumed, arguendo, the aforesaid transaction was a sale, the loss resulting therefrom would not be a carry-over net operating loss.

3. The Tax Court erred in holding that the legal, accounting and escrow expenses were non-deductible capital expenses.



FIRST SPECIFICATION OF ERROR—FINDINGS OF THE TAX COURT AND OBJECTIONS THERETO.

No objection will be interposed as to the accuracy of the Findings of Fact, other than those stated under the heading "Ultimate Findings of Fact". (R. 279.) The portions of the Transcript of Record hereinafter noted and quoted are intended to supply omissions of fact that are considered significant and to clarify some inconsistencies.

(A) With reference to the efforts of petitioner to sell corporation assets, consisting of inventory and related items, prior to 1951, the Tax Court found as follows (R. 260-261):

"Prior to 1951, the directors of the petitioner paid a good deal of attention to a continuing problem of high inventories in the mercantile business which reflected a slowing down of sales of certain items. From time to time certain types of merchandise which were not selling quickly or profitably were discontinued. The directors instructed the manager of the store to increase his efforts to sell larger quantities of merchandise and to reduce inventories of unprofitable lines of goods. In about 1945 and thereafter, petitioner's president gave consideration to the possibility of selling petitioner's mercantile business but petitioner never received and its directors never considered any specific offer of anyone to purchase the business."

(a) The testimony of John P. McEnery, President of petitioner-corporation, was as follows:

After testimony concerning a plan to divide the corporation into two corporations (R. 66):



“Q. What was your next plan?

A. The next plan was to approach it from the idea of selling the business.

Q. To whom?

A. To any buyer, anybody that would buy it, or selling the real estate, too. We had discussed that, selling the whole thing, to get out of it.

Q. Were any efforts made in that direction during the year 1951?

A. Yes sir, it was. There were.

Q. Could you say or estimate on the basis of your own recollection the number of attempts that you personally made to interest others in buying the retail business, that is, the inventory and other related assets that represented that business?

A. I talked to any reputable firm, both in San Francisco and San Jose, many of them that I knew.

Q. Could you name a few?

A. Yes. A Mr. Gunn, who is now in business in San Jose, who was then with Coldwell & Banker Company; Clayton & Company, the biggest real estate office in San Jose; the manager of Blythe & Company in the Bank of America, San Jose, Mr. Paul Muth; a gentleman by the name of Crist in Los Gatos came to us—it is in the minutes here someplace—and offered us, wanted to get an exclusive on the sale of the real estate alone.”

Later, Mr. McEnery on direct and cross-examination (R. 204 to 209):

“Q. (By Mr. Yeo) In connection with your previous testimony, Mr. McEnery, concerning your efforts to sell the retail hardware business

prior to 1951, I believe you testified that you had made a number of attempts to sell this business, either wholly or in segments, that were unsuccessful.

Mr. Yeo. Would you mark this for identification?

The Court. 31 for identification.

(Petitioner's Exhibit No. 31 was marked for identification.)

Q. (By Mr. Yeo). I will show you Petitioner's Exhibit 31 for identification and ask you to identify it.

A. That is a letter that I received from Blythe & Company, a Mr. Paul Muth.

Q. Would you state briefly the substance of that letter?

A. On December the 27th, 1950—I might as well read it, it is short—'There appeared an article in the Mercury to the effect that a new corporation was being formed to separate the business of The Farmers Union Store from the real estate property and that the new corporation would operate solely in the hardware business. Since seeing the article in the paper, I have been wondering whether there is any chance that some time in the future the controlling factors in the corporation might be interested in selling out the hardware business. I feel very sure that if you would consider selling, Blythe & Company would be able to get you a very attractive offer. I would appreciate very much if you would put this letter on file and remember to give us an opportunity to obtain a purchaser if you consider selling.

'(Signed) Paul Muth.'

This letter was written January 2nd, 1951.



Q. Was any action taken by you or any representative of The Farmers Union Corporation in response to this letter?

A. Many conferences were held with Mr. Muth in San Jose, and a meeting was held in San Francisco with Blythe & Company.

Q. Did you receive any other letters or correspondence of the same character during the period of 1949 to 1951, inclusive?

A. I received many letters.

Q. Do you have any other letters of a similar character?

A. Well, Mr. Yeo——

Mr. Munter. Just answer the question, please.

The Witness. What was the question?

The Court. Read it.

(Last question read.)

Q. (By Mr. Yeo) I said: 'Did you receive any other letters of a similar character?'

A. Yes.

Q. Do you have any such letters or copies of such correspondence available to you now?

A. No, I have not.

Q. Why not?

A. Because in 1952 we had an employee who was office manager, Mr. Gallagher, go sour on us, and shortly before he committed suicide here in San Francisco by jumping off the Bridge, he set the records of the store, practically boxes and boxes of records, on fire; he put them in the incinerator and burned them. Among those was the correspondence that I had stored in the warehouse in a file. The letters that I was able to find, the only letters that I was able to find, were the letters that I had in my own possession, in my personal file, either at home or in my office at my home. It is impossible to find any more,



but I am sure that the record could be more complete by bringing in other witnesses, such as Clayton & Company, which I had signed an exclusive agreement with at one time to sell the business and the building——

Mr. Munter. I believe we are exceeding the scope of the question and the interest——

The Court. Go ahead. The objection is overruled. Continue.

A. (Continuing) Blythe & Company, Clayton & Company, Coldwell & Banker Company, the man that I mentioned in Los Gatos—I mentioned it the other day, I can't even think of it now, an older gentleman who has a very prominent real estate office there. At Coldwell & Banker, I dealt with a Mr. McCulloch, who is still there, in San Francisco, and on a number of occasions I dealt with Mr. Phair in Los Angeles who is with Coldwell & Banker in Los Angeles. And they had tried to interest any number of people in the purchase of the whole Farmers Union setup.

Q. (By Mr. Yeo) And all of this occurred prior to 1951?

A. Yes.

Q. And that is your clear recollection?

A. Yes. I have a clear recollection of it, yes, I have.

Mr. Yeo. That is all. You may cross-examine.

The Court. That wasn't offered, but I suppose you ought to offer it.

Is there any objection to 31?

Mr. Munter. We have no objection to 31, your Honor.

The Court. 31 is received in evidence.

(Petitioner's Exhibit 31 was received in evidence.)

The Court. Now you may inquire.

## Cross-Examination

By Mr. Munter:

Q. What was the time that you were having these conversations with Mr. McCulloch and Mr. Phair? Was this in 1951?

A. I would say that it ran from, anywhere from 1947 or '48 up to '51. In fact, we are still having conversations with him, we are in the act of discussing, we couldn't make a sale so now we are discussing trades.

Q. After you got this letter, Exhibit 31 in evidence, did you then have additional conversations with Mr. Muth?

A. Yes, and a number of letters where we signed up with Blythe & Company.

Q. Didn't he say in this letter that he could get you a very attractive offer? Isn't that what the contents of this letter are?

A. Yes. And he never did.

Q. Just answer the question, please.

A. Yes, sir.

Q. Now, after this letter was written, in which Mr. Muth stated he could find you an attractive offer, that he could find you attractive offers you proceeded with your plan to divide the corporation into two separate corporations, isn't that correct?

A. No, sir.

Q. Isn't it correct, didn't the directors make a resolution and the stockholders make a resolution directing the directors to divide the corporation into two corporations, after the date of this letter?

A. Yes, after the date of the letter. Six months afterwards, five months afterwards."



Mr. Louis A. Rossi, Director and former general manager of petitioner, testified as follows (R. 219 to 221) :

“Mr. Yeo. I interrupt, Mr. Rossi, in order to conserve the time of the Court and request that you confine your review of the situation to those matters bearing upon the final decision of the corporation to transfer the retail hardware business to the stockholders.

The Witness. Yes, I will.

A. (Continuing.) Shortly after the close of the war, The Farmers Union Corporation was showing losses in its business, there was quite a bit of pressure brought to bear on the directors on the part of the stockholders, both small and large, to sell the retail end of the business. Mr. McEnery attempted to buy the retail end of the business. The directors thought it was only fair that the stock be offered for sale to the stockholders. Every stockholder was given an opportunity to purchase the stock. In fact, Mr. Benson, it is a matter of record that he indicated that he would step aside and let the stockholders buy whatever they wanted of the 8,000 shares, and that he would take the balance.

Q. To your recollection, did the board of directors ever discuss or consider the possibility of selling the merchandise representing the retail business in segments or in, by departments, in an attempt to eliminate the inventory ultimately?

A. Yes, they have discussed that on many, many occasions. In fact, we even went so far as to discuss the liquidation of the inventory by either sale in small portions or by sale under auction.



Q. What was your conclusion on that?

A. My conclusion was that if we had sold the inventory, amounting to \$284,138.79, and the fixtures and trucks and accounts receivable, that the corporation would have suffered a loss of approximately \$200,000.00.

The Court. What do you mean by that? What do you mean by 'if we had sold'?

The Witness. For the reason that——

The Court. Wait a minute.

The Witness. Excuse me.

The Court. There is a big 'if' there. You say 'if we had sold'.

The Witness. Your Honor——

The Court. If you had sold to whom?

The Witness. If we had sold by liquidation to the public through auction, in a forced sale, the most we could have received would have been about 50 cents on a dollar, the corporation would have suffered a loss of approximately \$200,000.00.

Q. (By Mr. Yeo.) That estimate of yours, Mr. Rossi, of a loss of \$200,000.00, is it based merely on estimates, or did you have pending offers or discussions in proposals of purchase of these corporate assets?

A. It is based on 25 years of experience in the retail merchandising management.

Q. Were there any discussions in your presence with people——

The Court. He has answered your question now. He says that is his estimate based on his own experience.

Q. (By Mr. Yeo.) This represents your own personal estimate?

A. Yes.

Q. Did you present this estimate to the board of directors?

A. We discussed it at a board of directors' meeting."

On re-direct examination of Mr. Rossi (R. 246 and 247):

"Q. (By Mr. Yeo.) You attended all of the board of directors' meetings in the year 1951?

A. Yes, sir, I did.

Q. And you testified on cross-examination that during the course of these meetings you did not learn of any specific offer that was made to buy the merchandise of the corporation, is that true?

A. That is correct, sir.

Q. During the course of these meetings of the board of directors, did you learn or did you receive any reports of representatives of the corporation who had conversations on the subject of a possible sale or a transfer of the merchandise representing the inventory?

A. Reports of discussions, yes. But nothing specific.

Q. So you knew of your own knowledge that, then, negotiations had actually been conducted along the line of possible sale or exchange of the merchandise representing the inventory of the corporation.

Mr. Munter. I will object to that as a conclusion, as calling for a conclusion——

The Court. The objection is sustained. And the objection is sustained for this reason: This witness was one of several directors. He attended some meetings. The reports that were made have not been identified, and his answer is

too much in the nature of hearsay for me to be able to give any weight to it.

Mr. Yeo. I will strike the question, withdraw the question.

The Court. Reframe your question.

Q. (By Mr. Yeo.) In the course of the board of directors' meetings did you hear, yourself, of any reports directed to the board of directors bearing on the subject of negotiations for the sale of the corporation property?

A. Yes, sir, I did.

Q. How many times did you hear that during the year 1951?

The Court. Who made these—excuse me, please—who made such reports to the board of directors?

The Witness. Mr. McEnery reported at every monthly meeting on his various discussions with prospective buyers. But none were interested in buying the assets of the business.

Mr. Munter. I will object to that. This is mere hearsay, as to what the buyers did or did not do. Mr. McEnery is——

The Court. The objection is overruled.

A. To the best of my knowledge——

The Court. You have answered the question.

Mr. Yeo. Don't volunteer anything."

(b) Concerning petitioner's plan to exchange corporate assets for stock, the Tax Court found as follows (R. 267 and 268):

"The plan of petitioner's directors for the 'division and segregation' of the operation of the real properties of petitioner from the ownership and operation of the merchandising business of



petitioner which was approved and adopted by the stockholders on June 7, 1951, listed the categories of assets which were primarily used in the merchandising business (such as accounts receivable, merchandise inventory, autos and trucks, furniture and fixtures, and prepaid items) which were to be transferred to stockholders in exchange for 8,000 shares of stock, and the plan also listed the types of liabilities which the transferees were to agree to assume, but nowhere in the plan was there stated the value of all or any item of the assets to be transferred or the amount of any liability which was to be assumed except that a note of petitioner payable to the Bank of America in the amount of \$70,000 was stated as a specific liability to be assumed. In other words, no total value of the assets to be transferred and no total amount of the liabilities to be assumed by the transferees in exchange for 8,000 shares of stock was stated in the plan. The plan provided only that, in general, all of the assets used in the merchandising (hardware) business, subject to liabilities, were to be transferred to those who surrendered 8,000 shares of stock, and that for each share of stock surrendered each person entering into the transaction would receive a one/eight-thousandths interest in the transferred assets."

This finding is inconsistent with a preceding fact wherein determination of the value of the assets offered by petitioner was clearly set forth by the Tax Court, as follows (R. 264):

"The plan required that stockholders make their decision not later than June 14, 1951.

There was attached to the notice to the stockholders of the special meeting a balance sheet showing the assets which were to be transferred in exchange for stock and the assets to be retained by petitioner if the stockholders approved the plan. Petitioner's accountant prepared the statement from petitioner's books. He was told that the plan was to sell the mercantile business assets and he used that word in the statement. The stockholders were accordingly advised about which assets might be exchanged for stock. The dollar amounts in the statement were the amounts at which the assets and liabilities were carried on petitioner's books, i.e., cost or cost less depreciation. The statement sent to the stockholders prior to June 7, 1951, was substantially the same as the statement set forth below which was prepared by the accountant in July, as of June 30, 1951."

Following the above finding, the Tax Court set forth a replica of the financial statement reflecting the identity and the valuation of the assets and liabilities "To be Sold" and "To be Retained", in conformance with the plan submitted to the stockholders. (R. 265; Exhibit 22.)

In connection with the preparation of the above mentioned financial statement, the following is the testimony of T. D. Caldwell, accountant for petitioner (R. 133 to 139):

"Q. In connection with the assets that were proposed to be transferred by the corporation to those stockholders who would be willing to exchange shares of capital stock, I will ask you



whether in connection with that you had occasion to examine the books and records to determine the costs of the items to be transferred.

A. I did.

Q. And you made an original examination of all the books and records of the corporation in order to determine, in order to obtain that information?

A. That is correct.

Q. Did you have any instructions with reference to the date on which the evaluation would be computed in order to determine the tax effect upon the corporation and the individual stockholders involved?

A. I don't quite follow your question, Mr. Yeo.

Q. Did you receive any instructions as to the date on which the evaluation would be made of the assets to be transferred?

A. I think that I was informed by the board of directors of the corporation that they were going to try to get the partnership or whatever entity they entered into by the 1st of July, and that they would like to have a balance sheet and statement, profit and loss statement, and so forth, as of June 30th.

Q. Because of those instructions, did you thereupon prepare a balance sheet and a summary of the information that they required?

A. I did.

Q. I will show you a balance sheet on which are listed assets and liabilities and, over at the right, in separate columns, assets to remain in the corporation and assets to be sold, and ask you if you prepared that balance sheet?

A. I did.



Q. Did you prepare that from the original books and records of the corporation?

A. I did."

After Mr. Caldwell identified the various items set forth in the financial statement, he testified further, as follows (R. 137 to 139):

"Q. I will show you this duplicate, or this balance sheet here, and ask you if that is a photograph of your original balance sheet?

A. It is.

Mr. Yeo. I will offer this balance sheet in evidence, if your Honor please.

(Testimony of T. D. Caldwell.)

Mr. Munter. We are going to object to the characterizations of the transactions that appear on here. He has 'Assets to be Sold,' and that is——

Mr. Yeo. They were segregated for the purpose of making them available for transfer to persons to whom they would be sold.

Mr. Munter. That is assets to be exchanged in redemption of stock; to characterize it as a sale is disposing of the whole problem here.

Mr. Yeo. This is the way the document was originally prepared. I have no authority to change what was originally written.

Mr. Munter. The characterization that the accountant gave to the transaction is obviously of no value here, to the extent that if he had no knowledge of the transaction at all——

Mr. Yeo. Well, I am offering this in evidence for whatever value it may have if your Honor please.

The Court. Who told you to use these designations, like 'To be sold,' and so forth?

The Witness. That was, your Honor, I met with the board on a great many occasions, and particularly during this period when they were thinking of trying to sell——

The Court. Just be brief about it. You were told by members of the board, were you?

The Witness. No. That was the term that they were using during all of the conversations.

The Court. Well, that would boil down to the same thing. You were told by members of the board to make a segregation?

The Witness. That is correct.

The Court. Is that it?

The Witness. Yes.

The Court. The Respondent has stated his objection and the exhibit is received for what it is worth as Exhibit 21—is that the next number?

The Clerk. This has not been marked, your Honor, so the next number would be Exhibit 22.

The Court. Exhibit 22.”

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#### SECOND AND THIRD SPECIFICATIONS OF ERROR.

Petitioner believes that the right to carry over the net loss of the corporation in 1951, to succeeding years and the right to deduct expenses incident to the transaction here in controversy, are questions of law and procedure and that such rights should be established, as a matter of law, in favor of petitioner.

## ARGUMENT

FIRST SPECIFICATION OF ERROR—THE TAX COURT ERRED IN HOLDING THAT THE TRANSFER OF CORPORATION PROPERTY IN EXCHANGE FOR CAPITAL STOCK OF THE TRANSFEROR (PETITIONER) WAS A DISTRIBUTION IN PARTIAL LIQUIDATION IN WHICH NO GAIN OR LOSS MAY BE RECOGNIZED FOR INCOME TAX PURPOSES.

The Findings of Fact by the Tax Court, except the Ultimate Findings of Fact (R. 256-278), as supplemented by portions of the record, quoted above, and by stipulation (R. 11-14), disclose a pattern of events from which this controversy developed, as follows:

1. At the beginning of taxable year 1951, petitioner owned and leased real property, in addition to owning and operating a retail hardware store, in San Jose, California. (R. 258.)

2. During the several years immediately preceding 1951, petitioner had also engaged in the business of retail sales of tires and auto accessories, groceries, meats and household wares. (R. 229 and 258.)

3. Prior to 1951, all the retail business activities of petitioner, except hardware, garden tools and related merchandise, had been terminated by liquidating sales to the public. (R. 51-52; 229-230.)

4. From 1948 to 1950, increasing dissatisfaction with the retail hardware business caused petitioner's Board of Directors to give consideration to the following described successive remedial plans, the first three of which were rejected, to-wit:

(a) Reduction of inventories and improvement of merchandising techniques. (R. 55-58; Exhibits 6, 7, 8 and 9.)



(b) Formation of another corporation and a subsequent exchange of petitioner's inventory and fixtures for stock, in a plan of reorganization. (R. 59-65; Exhibits 10, 11, 12 and 13.)

(c) Sale of the hardware business, as such, or liquidation of the assets by public sale or auction. (R. 204-207; 219 and 220.)

(d) Transfer of the business inventory, together with related assets and liabilities, in exchange for 8,000 shares of petitioner's outstanding capital stock and a 20-year lease of the store space by the transferees at the rate of \$18,000.00 per year. (R. 69-81, 221-225; Exhibits 2-B, 3-C, 14, 15 and 16.)

5. Pursuant to adoption of plan (d), above, seven stockholders surrendered 8,000 shares of petitioner's capital stock in exchange for a proportionate undivided interest in the corporate assets offered. (R. 82-87; 198-199; Exhibit 30.)

6. The aforesaid seven stockholders thereafter formed a partnership which was later reduced to three partners. (R. 87-90; 269-271; Exhibits 4-D, 17.)

7. Coincident with the formation of said partnership, petitioner executed and delivered a Bill of Sale conveying the assets and liabilities described, in Exhibit 22 and R. 265, to the partners. (R. 169-170; Exhibit 5-E.) Petitioner received in exchange therefor the 8,000 shares of its capital stock and a lease by the partnership of the premises in which the hardware

business was located, covering a period of 20 years at \$18,000 per year rental. (R. 79; 124-126; 221; 272.)

8. Subsequent to the transfer of corporation property for stock and the lease, petitioner reduced its stated capital from 20,000 shares to 12,000 shares, by resolution of its Board of Directors, dated August 16, 1951 (Exhibit 18) and ratification thereof by the corporation's stockholders, on February 13, 1952. (Exhibit 19; R. 91-94; 230-232; 273.)

The Tax Court held this transaction to be a distribution of the assets of the petitioner "in partial liquidation in redemption of the surrendered stock, and that there was not a sale of the assets for stock. The facts of the transaction bring it within Sections 115(c)<sup>1</sup> and 115(i),<sup>2</sup> Section 29.22(a)-20, Regulation 111<sup>3</sup> applies." (R. 291)

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NOTE: All statutory references herein are to the Internal Revenue Code of 1939 and the Regulations pertaining thereto.

<sup>1</sup>*Section 115—Distributions by Corporations*

(c) *Distributions in Liquidation*

"Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock." The remainder of this section applicable in determining whether such distributions are out of capital or earnings.

<sup>2</sup>*Section 115—Distributions by Corporations*

(i) *Definition of Partial Liquidation*

"As used in this section the term 'amounts distributed in partial liquidation' means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."

<sup>3</sup>*Section 29.22(a)-20, Regulation 111—Gross Income of Corporation in Liquidation*

"When a corporation is dissolved, . . . Any sales of property by them are to be treated as if made by the corporation for



It may be observed that Section 115(c) is clearly inapplicable to the "facts of the transaction". A reading of that section and its corresponding Regulation (29.115-3) will disclose that the substance thereof is directed exclusively to the income tax responsibilities of *stockholders* who receive distributions from corporations in the process of liquidation. Neither the statute nor the Regulation have any bearing upon the determination of the income tax liabilities of the liquidating corporation. Furthermore, in order to make the "facts of the transaction" susceptible to judicial consideration, in the light of all of applicable law, Section 29.22(a)-15 of Regulation 111 should be included.<sup>4</sup> This particular Regulation contains the

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the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition."

<sup>4</sup>*Section 29.22(a)-15—Acquisition or Disposition by a Corporation of Its Own Capital Stock.*

"Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances."

"However, if a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code."



standard requisite of an examination of “the real nature of the transaction” in order to determine whether acquisition by a corporation of its own stock “gives rise to taxable gain or deductible loss.”

It is respectfully suggested that the “real nature of the transaction” would be more readily discernible from an examination of the definition of “partial liquidation”, as set forth in Section 115(i) of the Internal Revenue Code, *supra*. This appears to be of primary significance because if a transfer by a corporation of a substantial portion of its assets, by a bill of sale, to seven of its 134 shareholders in exchange for 8,000 of the 20,000 outstanding shares of capital stock, is a partial liquidation, as defined by statute, the other “facts and circumstances” can be of very little consequence. On the other hand, if the instant transaction is not within the scope of that definition, it cannot be other than a taxable exchange, within the purview of both Regulations 29.22(a)-15 and 29.22(a)-20, *supra*, as well as Section 111, Internal Revenue Code and its corresponding Regulation.<sup>5</sup>

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<sup>5</sup>*Section 111—Computation of Gain or Loss*

“The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . for determining gain, and the loss shall be the excess of the adjusted basis . . . over the amount realized.”

*Regulation 111, Section 29.111-1*

“Except as otherwise provided, the Internal Revenue Code regards as income or as loss sustained, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or extent.”

The Tax Court apparently predicated its conclusion that this was a partial liquidation on the following observations:

- (a) The minutes of the stockholders' meeting of June 7, 1951 (Exhibit 16) contained the words "proposed method of partial liquidation". These words were regarded as having "greater weight" than all of the other references to the corporation's plan to transfer assets for outstanding capital stock (R. 288-289).
- (b) "The plan was not drawn in terms of purchase and sale, and no selling price of the assets was stated" (R. 288).
- (c) Petitioner's directors adopted a resolution reducing the corporation's stated capital by the number of shares received in the transaction, which resolution was later ratified by the stockholders (R. 290).
- (d) "Petitioner's business operations were substantially contracted" as a result of the transaction (R. 290-291).

None of the cases cited by the Tax Court and none of the cases examined by petitioner give judicial support to or approval of any of the above noted facts as being determinative or even influential in identifying a partial liquidation, as defined in the Internal Revenue Code (Section 115(i), *supra*). That statute is clear, succinct and specific in defining distributions by a corporation in partial liquidation to be for the exclusive purpose of "cancellation or redemption" of its stock. Accordingly, it would appear that a true partial liquidation would require the alteration or revision of the capital structure of the



corporation as the primary purpose for the distribution and the cancellation or retirement of the capital stock received thereby, to effectuate that purpose.

The substance of the transaction, not the form or the words used in connection therewith, determines the character of the exchange of corporate property for its own stock. *Allyne-Zerk Co. v. Commissioner*, (83 F.(2d) 525; *Commissioner v. S. A. Woods Machine Co.*, 57 F.(2d) 635; *Niagara Share Corporation*, 30 B.T.A. 668; *Spear & Co. v. Heiner*, 54 F.(2d) 134, 136.

Judicial examination of the substance of transactions that are similar to the one here in controversy has established strong precedent for the conclusion that petitioner was a party to a taxable exchange, rather than engaged in partial liquidation. In *Commissioner v. Boca Ciega Development Co.*, 66 F.(2d) 1004, the corporation exchanged a piece of its land for shares of its outstanding stock. In holding the gain to the corporation to be taxable income, the Court stated, in part, that “. . . the courts have held that a corporation acquiring its own stock may recognize a gain or a loss, provided the purpose of the transaction was not merely a capital readjustment”.

In *Dorsey v. Commissioner*, 76 F.(2d) 339, the corporation sold the building that housed its plant and took a lease back. It received \$100,000, represented by 1,000 shares of its own stock and \$62,000 in money, as consideration for the transfer. After the transaction, the purchasers continued to hold considerable stock in the corporation. In the Court's opinion, the



value of the stock received must be included in computing gain or loss, the established principle being that when, in a business exchange, the transferor receives its own stock, it is converting by sale a previous purchase and if what it receives has a fair market value, the gain or loss realized in the exchange must be measured and taxed. In this connection the Court commented that "It is not the purchase of the stock but the sale of the real estate that is regarded."

In *Hammond Iron Co. v. Commissioner*, 122 F.(2d) 4, the corporation, by resolution, authorized the president to purchase for a certain sum shares of its outstanding stock and to pay cash or other assets, or both, to acquire such stock. The corporation acquired the stock, as authorized, with assets having an adjusted cost in excess of the value of the stock received. The Commissioner denied the loss, declaring the transaction to be a partial liquidation and not a sale of corporate assets. The Court, citing the *Dorsey* case, *supra*, stated, "It does complete violation to the facts to treat the transaction as a partial liquidation with the payment of a liquidating dividend and the surrender of stock for cancellation. Such a position is wholly untenable in fact and in law, for no single element of a liquidating dividend is present. It was a transfer of assets in payment of stock. It was nothing more." Further, the Court observed that "It is a loss not on purchase of stock but on the sale of assets given for the stock."

In *Trinity Corporation v. Commissioner*, 127 F.(2d) 604, the corporation exchanged its principal asset for

other real estate and its own stock. On the question of whether the value of the corporation's own stock, received by the corporation in the transaction, should be considered in determining its gain or loss, the Court, also citing the *Dorsey* case, *supra*, made this comment: "This Court has held that the *receipt by a corporation of its own stock and other property in exchange for its real property is a conversion, by sale, of a previous purchase*; that gain or loss resulting from such sale of corporate property for its own stock is realizable" . . . under existing laws and regulations.

In *Spear & Co. v. Heiner*, *supra*, the corporation owned five furniture stores. It sold one of them to one of its stockholders and accepted payment therefor in shares of capital stock. The adjusted costs of the assets transferred were in excess of the value of the stock received and the corporation claimed a loss on the transaction. The Court held that a deduction was allowable, as the transaction was a sale, the consideration being the seller's own stock.

See also, *Johnson McReynolds Chevrolet Co.*, 27 T. C. 300, 303, and *Country Club Estates, Inc.*, 22 T. C. 1283, 1287, 1292-3.

The cases, in point, cited by the Tax Court (R. 288, 290, 292) also corroborate the principle that a distribution in partial liquidation must be for the purpose of a capital adjustment in which cancellation or retirement of the corporation's stock is an essential element.<sup>6</sup>

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<sup>6</sup>These cases are briefed in Appendix "B" hereof.



In this case, the facts and circumstances clearly demonstrate that the sole motive, purpose and objective of petitioner was to alienate its hardware inventory and related property in the best transaction that could be arranged. Under the plan that was finally adopted, after consideration of other plans, petitioner executed and delivered a bill of sale to a partnership comprised of those stockholders who had accepted petitioner's offer to exchange property for stock. Both the partnership agreement and the bill of sale recited a valid consideration, the dollar value of which was known and easily ascertainable by the parties.

When petitioner received the 8,000 shares of its stock as consideration for the conveyance of corporation property, the stock was not cancelled or retired. Reduction of stated capital by resolution of the Board of Directors, ratified by stockholders, did not involve or require cancellation or retirement of stock as a result or prerequisite. The resolution was made in recognition of the reduction in outstanding shares and the effect thereof was to restore the shares acquired by the corporation to the status of authorized but unissued shares.<sup>7</sup> Thus, the financial structure of

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<sup>7</sup>*California Corporations Code*

"1700. A Corporation may redeem any or all shares which are redeemable at its option by (a) giving notice of redemption, and (b) payment or deposit of the redemption price of the shares as provided in its articles . . ."

"1706. A Corporation may *purchase*, out of stated capital or out of any surplus, shares issued by it, . . . in any of the following cases:

(a) To collect or compromise in good faith a debt, claim, or controversy with any shareholder.



the corporation was unaffected by the receipt of its stock. Also, under California law, petitioner's outstanding stock, being capital stock authorized by its Articles of Incorporation, was not subject to redemption, within the purview of Sections 1700 and 1706 of the California Corporations Code. (See footnote 7, *supra*.)

There appears to be no judicial authority for the finding by the Tax Court that the contraction of petitioner's business operations, resulting from its exchange of property for stock, was indicative of partial liquidation. The only case cited in support of this conclusion was *Pacific Vegetable Oil Corp. v. Commissioner*, 251 F.(2d) 682. (R. 290-291.) In that case, this Court reversed the Tax Court, holding that petitioner, a stockholder in another corporation, had received a dividend under Section 115(g), from the other corporation which had redeemed petitioner's stock. The Tax Court had previously decided that the distribution to petitioner had been in partial liquidation.

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(b) To eliminate fractional shares.

(c) To redeem or purchase shares subject to redemption at prices not exceeding the redemption price thereof.

(d) From any shareholder who by reason of dissent from any proposed corporate action is entitled . . . to be paid the fair market value of his shares.

(e) From one who as an employee other than as an officer or director has purchased the shares from the corporation under an agreement reserving to the corporation the option to repurchase the shares."

"1710. When a corporation acquires its shares out of stated capital, under Section 1706, such shares are restricted to the status of authorized but unissued shares, and the stated capital may be reduced by resolution of the Board of Directors by the amount of stated capital attributable to such shares."

"1904. A reduction of stated capital may be authorized by a resolution of the Board of Directors approved by the future or written consent of the holders of a majority of outstanding shares . . ."

tion. As one of eight reasons for holding the distribution to be a dividend, this Court stated that "the purchasing corporation had adopted no plan or policy of contraction of its business".

On the other hand, in cases involving judicial consideration of the tax consequences to a corporation that acquired its own stock in an exchange, the financial or economic results of the transaction appear to be of no significance. In the *Allyne-Zerk Co.* case, *supra*, the corporation conveyed all of its property in exchange for its stock and cash. Similarly, in the *Trinity Corporation* case, *supra*, the corporation transferred its principal asset for its own stock and other property. Also, in the *Dorsey* case, *supra*, the corporation exchanged the building in which the corporation's business was located.

A careful examination of a number of cases of similar character has failed to disclose any instance in which judicial recognition of a business contraction or termination as the result of the acquisition by a corporation of its own stock has been at all persuasive in resolving the tax question involved. This so-called "business contraction" or "net effect" test appears to apply only to situations in which the legal question is (1) an individual's right to carry over a net operating loss, under Section 122(d)5, or (2) the tax status of a stockholder who has received a distribution that may be "substantially equivalent to a dividend", under Section 115(g).

The Tax Court's reference to petitioner's failure to comply with the Bulk Sales Law of California



appears to be of doubtful relevance to any issue in this case. (R. 289-290.) However, it may be observed that this statute is for the exclusive benefit of and available only to creditors who are prejudiced by a debtor's alienation of a large portion of his assets and does not prevent or invalidate a sale or transfer as between vendor and vendee or transferor and transferee. *Jeffrey v. Volberg*, 159 C.A.(2d) 815, 324 P.(2d) 964.

It is respectfully submitted that petitioner engaged in a taxable exchange in which the loss sustained may be recognized for income tax purposes, and did not, therefore, make a mere distribution of assets for the purpose of cancelling or redeeming its stock.

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**SECOND SPECIFICATION OF ERROR—THE TAX COURT ERRED IN HOLDING THAT IF IT BE ASSUMED, ARGUENDO, THE AFORESAID TRANSACTION WAS A SALE, THE LOSS RESULTING THEREFROM WOULD NOT BE A CARRYOVER NET OPERATING LOSS.**

In connection with petitioner's reported deductions in its income tax returns for 1952 and 1953, as a carryover of the unused net loss sustained in 1951, the Tax Court ruled that, even if such loss were recognized, the right to the carryover would not be available to petitioner in succeeding years, under Section 122(a).<sup>8</sup> The basis for this conclusion is a finding by

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<sup>8</sup>Section 122(a). *Definition of Net Operating Loss.*

As used in this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income, with the exceptions, additions, and limitations provided in subsection (d).



the Tax Court that the loss carryover may be utilized only by a taxpayer who continues in the same business during the years following the loss and that “substantial reduction” or termination of a business by reason of the loss transaction would forfeit the carry-over privilege.

Section 122(a) qualifies its definition of net operating loss with “exceptions, additions and limitations provided in subsection (d)”. The paragraph in that subsection that is pertinent here is Section 122(d)-5<sup>9</sup> which imposes restrictions on computation and carry-over of “non-business” losses. This statute specifically exempts corporations. However, prior to 1954, it would prevent individuals from carrying over excess losses from sales or exchanges of property to a “substantially reduced” or unrelated business activity in a subsequent year.

In each of the cases cited by the Tax Court in support of this ruling (R. 281, 286), except the *Lisbon Shops v. Koehler* case which is not in point because it involved a reorganization, it was an individual and not a corporation taxpayer who was denied a carry-over of a loss incurred in a transaction that substantially changed or reduced the character and scope of the business or was unrelated to the taxpayer’s principal business activities in the later years.

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<sup>9</sup>Section 122(d)-5.

Deductions otherwise allowed by law not attributable to operation of a trade or business regularly carried on by the taxpayer shall (in the case of a taxpayer other than a corporation) be allowed only to the extent of the amount of gross income not derived from such trade or business.

The Senate Finance Committee recognized this distinction between corporations and individuals when considering the intended effect of a revised statute covering net operating loss deductions (Section 172 of the 1954 code) and in its Committee Report on this proposed new legislation, made the following comments (pp. 212, 213):

“A further substantive change will permit taxpayers other than corporations who sell a business or certain business assets in effect to include any loss sustained on the sale of such business or business assets as part of a net operating loss for the year of the sale. (Corporations are entitled to this treatment under present law and under this section.) Thus, subsection (d)(4)(A) will overrule the decision in *Joseph Sic v. Commissioner* (10 T.C. 1096, 177 F. (2d) 649 (CA-8) certiorari denied, 339 U. S. 913), and similar cases, which held, for example, that a farmer who sold his farm at a loss could not include such loss as part of his net operating loss. The cases indicated that such loss was a nonbusiness loss since the taxpayer was not in the business of selling farms. The new provisions will reach the opposite result.”

The right of corporations to carry over (and carry back) losses sustained through sales of business assets, whether or not such sales were made in liquidation, is so well established, by reason of the unquestionable wording of the applicable statutes (122(a) and 122(d)-5), *supra*, that there are few cases in which the exercise of such right was in controversy.



The *Acampo Winery and Distilleries, Inc.* case, 7 T.C. 629, 639, gave the Tax Court an opportunity to decide on the extent to which a corporation may utilize these statutes in its deductions of business losses. Though the facts are distinguishable from those in this case, the principle involved is the same. The Winery corporation sold substantially all of its inventories and related properties to trustees representing its stockholders. Thereafter, for two years, the corporation continued in business pursuant to a plan of dissolution. During these two years, the Winery incurred losses which it carried back to the year of the sale, to reduce the taxable gain that was reported.

The Commissioner disallowed the carryback loss deduction, alleging that the corporation was “substantially liquidated and marking time” during the two years subsequent to the sale and “was no more the taxpayer it was in previous years, in substance and in fact, than if it had legally changed its existence”. The Commissioner also contended that Congress intended to accord this deduction “only where the same taxpayer was continuing to carry on substantially the same business in the loss years that it carried on in the taxable year”.

The Tax Court held that the deduction should have been allowed, stating: “The words in the statute are general in their application and something would have to be read into them that is not there to limit them so that they would not apply in this case”. See, also: *Diamond A. Cattle Co. v. Commissioner*, 233 F.(2d)



739 and *Oahu Beach & Country Homes, Ltd. v. Commissioner*, 17 T.C. 1472, 1479.

The opinion of the Tax Court contains considerable discussion of the technique employed by petitioner's accountant in reporting the income tax consequences of the transaction at issue in this case. (R. 281, 284.) This accountant has been in active practice since 1919. (R. 133.) When he prepared petitioner's 1951 income tax return, he faithfully transcribed therein all the information contained in petitioner's books and records, bearing upon its income tax liabilities. The exchange of corporation inventory for stock and the corresponding reduction of stated capital in recognition of the diminished number of shares outstanding after the transaction were correctly reproduced in the fiscal statistics reported for tax purposes.

In keeping with petitioner's contention that this transaction was a taxable sale or exchange, it would appear that the method of revealing the tax results thereof would be significant only if there appeared to be an erroneous computation of tax liability.

Petitioner's income tax return disclosed its hardware inventory, on June 30, 1951, as zero. The Commissioner determining the inventory on that date to be \$283,298.88 and then used that figure in computing petitioner's cost of goods sold. The income tax return of the partnership that acquired the property from petitioner reported the same amount as its opening inventory. Thus, the financial and tax consequences of the exchange were completely ignored.

The opinion did not declare that petitioner's method of computing the tax was wrong, and it is not clear as to what bearing, if any, the Tax Court's comments on the accountant's theory of reporting income had upon the insertion of a closing inventory figure for June 30, 1951. The Commissioner used that figure to give effect to his conclusion that the transfer of corporation assets was a partial liquidation, not because the accountant failed to perform his duties correctly.

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**THIRD SPECIFICATION OF ERROR—THE TAX COURT ERRED IN HOLDING THAT THE LEGAL, ACCOUNTING AND ESCROW EXPENSES WERE NON-DEDUCTIBLE CAPITAL EXPENSES.**

The available evidence clearly and completely discloses the nature and extent of the legal, accounting and escrow services rendered in connection with all phases of the transaction whereby petitioner transferred assets in exchange for stock. These services were obviously essential to the accomplishment of a plan that was directly related to the conduct of petitioner's business.

The Internal Revenue Code and the Regulations grant permission, in simple and unequivocal language, to deduct "trade or business expenses" from gross income in computing net taxable income.<sup>10</sup> The Tax

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<sup>10</sup>*Section 23 I.R.C. Deductions from Gross Income*

In computing net income there shall be allowed as deductions:

(a) Expenses.

(1) Trade or business expenses

(A.) "In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a



Court held these expenditures to be capital contributions to the change in capital structure that resulted from partial liquidation. The disallowance of the deductions claimed by petitioner as to these items would, therefore, appear to be the proper consequence to the judicial conclusion that petitioner distributed assets in partial liquidation, as defined by the Internal Revenue Code (Section 115(i), *supra*). To hold otherwise would create an obvious inconsistency. However, petitioner contends that allowance of these deductions is a matter of law, as well as being equally consistent with the recognition of petitioner's transfer of assets for stock as a taxable exchange.

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reasonable allowance for salaries or other compensation for personal services actually rendered;  
.”

*Regulation 111, Section 29.23(a)-1. Business Expenses.*

“Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. . . . The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business.”



**CONCLUSION**

It is respectfully submitted that the Tax Court was in error in the specifications set forth and judgment should be rendered in favor of petitioner.

Dated, San Mateo, California,  
September 18, 1961.

Respectfully submitted,  
RALPH A. YEO,  
*Attorney for Petitioner.*

**(Appendices A and B Follow)**



**Appendices A and B.**





## Appendix A

TABLE SHOWING ADMISSION OF EXHIBITS

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## Appendix B

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### CASES CITED BY THE TAX COURT BEARING UPON ITS CONCLUSIONS RE: TRANSFER OF CORPORATION ASSETS FOR ITS OWN STOCK

R. 288—*Lencard Corporation*, 47 B.T.A. 58

Petitioner-Corporation redeemed all outstanding preferred shares held by one stockholder for shares of another corporation held by Petitioner-Corporation, pursuant to a resolution of Petitioner-Corporation:

“Resolved, that all the outstanding preferred stock of this Company be redeemed and cancelled.”

When the shares of its own stock were received by Petitioner-Corporation, they were immediately retired and cancelled, resulting in no preferred stock thereafter in existence.

Appropriate action was also taken to that effect by Petitioner-Corporation by filing a “Certificate of Retirement of Preferred Stock Redeemed Out of Capital” with the Secretary of State of Delaware.

*Held:*

Transaction was partial liquidation because none of the essentials of a sale were present. *Considering the real nature of the transaction and the fact that the Corporation cancelled and retired the stock acquired*, rendered the action of the Corporation a true liquidation.

R. 288—*Commissioner v. Bedford's Estate*,  
325 U. S. 283

Question was whether an exchange of stock held by a shareholder for other stock and cash, in a reorgani-



zation of the corporation, was a dividend to the shareholder, to the extent of the cash received. The basic question involved Sec. 112, I.R.C., which is not applicable to any question before the Court in this case.

The only reference to Section 115(i) (definition of partial liquidation) was at pages 291 and 292, where the Supreme Court stated, in holding said Section 115(i) inapplicable:

“The definition of a ‘partial liquidation’ is specifically limited to use in Section 115. To attempt to carry it over to Section 112 would distort its purpose.”

*Held:*

Recapitalization under reorganization of a corporation does not alter the effect of a distribution out of earnings and profits as income to the shareholder to the extent of cash received in an otherwise tax free exchange.

R. 288-289—*C. M. Menzies, Inc.*, 34 B.T.A. 163, 164

Petitioner-Corporation transferred *all of its assets* to a stockholder who owned 90% of the outstanding stock, for approximately \$87,000.00, the Petitioner-Corporation taking the stockholder's note therefor. The Petitioner-Corporation's tax returns for the year of the sale (1931) had a balance sheet attached thereto showing no corporate assets or liabilities. Also attached to the return was a notation to the effect that all assets and liabilities of the Petitioner-Corporation had been purchased and/or assumed by the individual stockholder, as of July 1, 1931; that this transaction had been without profit or loss; and that the Petition-

er-Corporation “was abandoned after said disposal of net assets”.

The only issue was whether the transaction was a sale or distribution in liquidation.

*Held:*

*The transfer was a sale.* The facts show a purchase of corporation assets for cash or note. There was no exchange or surrender of stock which presumably continued to be outstanding in possession of the purchaser.

This case not in point, except to illustrate a pure sale for a stated amount, as compared to an exchange, where no dollar amount was stated, but with the consideration clearly described and valuations readily determinable.

R. 290-291—*Pacific Vegetable Oil Corp. v. Commissioner*, 251 F. 2d 682 9th Circuit

Petitioner-Corporation owned stock in another corporation, and offered to sell the stock back to it for cash. The offer was accepted and the stock was redeemed out of earned surplus. Petitioner-Corporation reported the proceeds of sale as a dividend under Section 115(g), I.R.C., claiming the 85% exclusion privilege under Section 26(b), I.R.C. The Tax Court held in accordance with the contention of the Commissioner that the distribution was in partial liquidation, under Section 115(c).

*Held:*

Tax Court reversed. *The redemption of stock has the same effect as a distribution of a dividend where (1) the offer is made by the stockholder;*



(2) the redemption was made from earned surplus; (3) the purchasing corporation adopted *no plan or policy of contraction of its business*; (4) the initiative for the corporate distribution came from the stockholder for its own purpose; (5) the relative position of the principal stockholders of the distributing corporation remained the same after redemption; (6) the capitalization at the time of cancellation of the redeemed stock represented earnings, not capital paid in; and (7) the net effect of the actions taken by the redeeming corporation was to leave it in the same position, insofar as operational purposes were concerned, as before the sale. Also (8) that the principal effect was to eliminate certain stockholders.

R. 291—*Lucius Pitkin, Inc.*, 13 T. C. 547

One of three stockholders surrendered his stock to Petitioner-Corporation, and received therefor certain corporation assets having a value approximately equal to this stockholder's original capital investment. The stock was cancelled by Petitioner-Corporation, and thereafter new stock, in same amount as dividend, was issued to two remaining stockholders.

*Held:*

Partial liquidation. “(pp. 552, 553) The object (of the exchange) was to eliminate Tour (the departing shareholder) and his stock from the organization, . . . The cancellation of the stock complies with the definition of partial liquidation in Section 115(i), I.R.C., for therein we find that partial liquidation means distribution in complete cancellation of a part of the stock. Tour's stock was not only surrendered, but cancelled.”



Petitioner-Corporation did not receive shares as consideration for property. *Its purpose in acquiring the stock was primarily to eliminate one shareholder.*

R. 292—*Brockman Oil Well Cementing Co.*, 2 T.C. 168

Petitioner-Corporation acquired 12½ shares of its capital stock from one stockholder in exchange for his ratable share of the Petitioner-Corporation's assets—for the *purpose of allowing the stockholder to sever all of his interest in the Petitioner-Corporation*, in accordance with his and other stockholders' wishes. Petitioner-Corporation held the redeemed shares and reissued them later. *Commissioner seeks to tax the gain to Petitioner-Corporation on the subsequent sale of the stock.*

*Held:*

Neither the acquisition nor the re-issue of the stock was taxable as dealing in its own shares as it would in shares of another. There was no purchase and sale of stock. The acquisition was to eliminate a stockholder by mutual agreement. The sale was to acquire additional capital.

R. 292—*Hill v. Commissioner*, 126 F. 2d 570

Stock purchased for *express purpose of cancellation*. Therefore, partial liquidation occurred.

R. 292—*Oscar G. Joseph*, 32 B.T.A. 1192

Not in point. Involves tax liability of an individual who acquired cash and notes as a stockholder of a corporation that had previously sold its assets in partial liquidation.

R. 292—*Salt Lake Hardware Co.*, 27 B.T.A. 482, 486

Petitioner was a corporation (A) that owned stock in another corporation (B). Corporation B redeemed its stock from Petitioner-Corporation A in two installments, covering two successive years, and thereupon retired the stock so redeemed. Petitioner-Corporation contended that the money received for the stock was essentially equivalent to a dividend and, therefore, not taxable income because of the statutory exemption as to dividends received by one corporation from another.

*Held:*

The distribution was in partial liquidation. Petitioner-Corporation argued that there was never any intent to liquidate and that redemption of the stock could not be considered as a partial liquidation. In commenting on that contention, the B.T.A. stated (p. 486): "That argument can have persuasive force only by using the word '*liquidation*' in the sense of winding up the affairs of the company. Admittedly that is the usual meaning of the word. *But here we cannot ignore the fact that Congress has established a different meaning for income tax purposes.* As set forth in the statute, . . . a partial liquidation takes place whenever a corporation distributes money or assets in complete cancellation or redemption of part of its capital stock".

R. 292—*Dill Manufacturing Co.*, 39 B.T.A. 1023

Petitioner was a corporation that *purchased and cancelled outstanding stock* from a syndicate of minority stockholders *to quiet dissension* that existed



between them and the majority stockholders. Payment was made in U. S. bonds, owned by Petitioner-Corporation, and a small amount of cash. At the time the bonds were transferred, they had a market value of less than cost. Petitioner-Corporation claimed a loss on the transaction. The Commissioner disallowed the deduction on the ground that the transfer was a non-taxable distribution in partial liquidation.

*Held:*

There was a partial liquidation, despite Petitioner-Corporation's lack of intent to liquidate. In this respect, the B.T.A. stated (p. 1030): "However, absence of intent does not contradict the statutory status of a liquidation if, in fact, a liquidation occurred, by the cancellation or redemption of capital stock".

R. 292—*Johnson, Carvell & Murphy v. Riddell*

(U.S.D.C., S. Dist of California), 173 F. Supp. 214

The Plaintiff, a corporation, exchanged some of its own property, consisting of stock in another corporation, for shares of its own outstanding stock and paid a tax on the capital gain derived thereby. Plaintiff then retired the shares so redeemed and sued for refund of tax paid, alleging that the transaction was a non-taxable distribution in partial liquidation.

*Held:*

Considering all the factors involved, the subject transaction was made in good faith and consisted of redemption in complete cancellation of the stock acquired, as provided in Section 115(i), I. R. C.



No. 17352

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**In the United States Court of Appeals  
for the Ninth Circuit**

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**THE FARMERS UNION CORPORATION, PETITIONER**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

---

**ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES**

---

**BRIEF FOR THE RESPONDENT**

---

**LOUIS F. OBERDORFER,**  
*Assistant Attorney General.*

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**FILED**

**1933**

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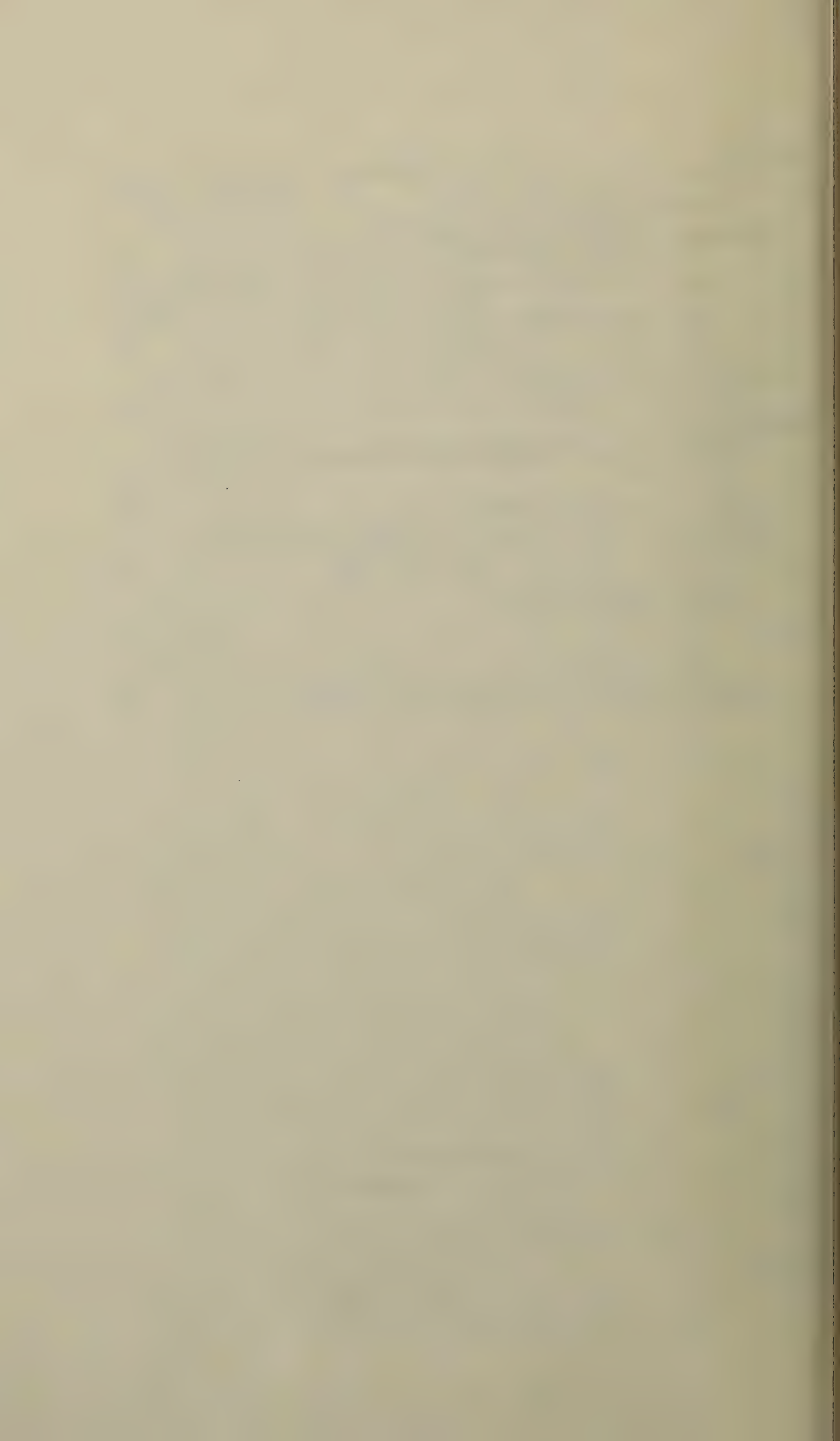
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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 17352

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THE FARMERS UNION CORPORATION, PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

---

*ON PETITION FOR REVIEW OF THE DECISION OF THE TAX  
COURT OF THE UNITED STATES*

---

**BRIEF FOR THE RESPONDENT**

---

**OPINION BELOW**

The memorandum findings of fact and opinion of the Tax Court (R. 254-295) are not officially reported.

**JURISDICTION**

This petition for review involves federal income taxes for the calendar years 1951, 1952 and 1953. On June 20, 1957, the Commissioner of Internal Revenue mailed to taxpayer a notice of deficiency for those years in the respective amounts of \$22,309.36, \$4,830.95, and \$7,676.72, for a total amount of \$34,817.03. (R. 5-6.) Within ninety days thereafter (*viz*, on September 3, 1957) the taxpayer filed in the

Tax Court its petition for redetermination of those deficiencies under the provisions of Section 272(a) of the Internal Revenue Code of 1939. (R. 3, 5-8.) The decision of the Tax Court finding deficiencies of \$22,309.36, \$4,800.95 and \$7,647.91 (aggregating \$34,758.22) for the years 1951, 1952 and 1953, respectively, was entered on October 25, 1960. (R. 299.) Within three months thereafter (*viz*, on January 19, 1961), taxpayer petitioned for review. (R. 300-301.) Jurisdiction is conferred upon this Court by Section 7482 of the Internal Revenue Code of 1954.

#### QUESTIONS PRESENTED

1. Whether the court below properly found that where the taxpayer segregated its mercantile business from its real property business and distributed the former to a partnership comprised of seven of its shareholders in exchange for shares of its capital stock, the distribution was a partial liquidation rather than a sale and therefore taxpayer did not realize any loss on the transaction.

2. Whether even assuming that the distribution of the mercantile business was made pursuant to a sale rather than a liquidation, there was no recognizable gain or loss from the exchange since the transferees own more than 50% of taxpayer's stock.

3. Whether taxpayer failed to satisfy its burden of proof as to the fair market value of the capital stock received by it and therefore failed to demonstrate that in fact it suffered any loss.

4. Whether the Tax Court properly determined that certain expenditures of taxpayer for legal and ac-

counting services incident to the distribution in partial liquidation were capital expenses.

#### STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*.

#### STATEMENT

The relevant facts as found by the Tax Court are as follows:

Taxpayer, a California corporation, was organized in the year 1874 and since that date has operated its business in San Jose, California. (R. 257.) For many years, the primary business of taxpayer was the operation of a general country store which sold numerous varieties of items, e.g., groceries, household wares, paints, gardening tools and builders' hardware. As time went on, taxpayer also became engaged in the real estate business, owning, among other properties, the land and building from which its business was conducted. The upper part of that building was leased as a hotel. (R. 258.)

During the early years of taxpayer's business, San Jose was a small community serving farmers in the Santa Clara valley. As San Jose grew into a substantial city, taxpayer's competition increased and consequently changes were made in its mercantile business. The operation of some of the departments in its store became unprofitable and in 1940, taxpayer closed its grocery and meat departments and limited its mercantile business to hardware. (R. 258.)



Even after that contraction, the directors and shareholders of taxpayer were concerned about the operation of a mercantile business. From about 1945 to 1951, taxpayer's president considered selling the mercantile business, but no specific offer was ever received by taxpayer or considered by its directors. (R. 260-261.)

In 1950, taxpayer's directors proposed that a new corporation be formed and that taxpayer's real estate business be "spun off" to the new corporation in return for the latter's stock which was then to be distributed to taxpayer's shareholders. The shareholders approved this plan, but it was never executed.<sup>1</sup> (R. 261-262.)

On May 17, 1951, McEnery, taxpayer's president, submitted to the directors a plan for the segregation of taxpayer's mercantile business from its realty business "by means of a sale of some of the assets of the corporation to the stockholders in exchange for the capital stock." Taxpayer's secretary and attorney, Kirby,<sup>2</sup> was authorized to draft a resolution concerning the plan and to prepare for its execution. (R. 262.)

At that time, taxpayer had authorized an outstanding 20,000 shares of common stock having a par value of \$10 per share so that its stated capital was \$200,000. (R. 259, 273.) Of this stock, McEnery owned 6,236 shares (about 31%) and Robert F. Benson owned 8,017 shares (about 40%). Together, Ben-

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<sup>1</sup> The testimony of McEnery, taxpayer's president at the time involved, indicated that tax considerations prevented the performance of that plan. (R. 65.)

<sup>2</sup> Kirby was also a member of the board of directors. (R. 259.)

son and McEnery held approximately 71% of the taxpayer's outstanding stock. The remaining shares were held by 132 persons, most of whom held stock in small lots from three to one hundred shares. (R. 259-260.)

At a special meeting of the directors on May 22, 1951, a resolution was adopted approving a plan whereby taxpayer would offer to its shareholders the opportunity to exchange for 8,000 shares of taxpayer's stock all of the assets used in and constituting its mercantile business. The plan further provided that if the exchange were executed, the taxpayer would give a 20-year lease to the transferees of the ground floor of the building at an annual rent of \$18,000. (R. 262.)

A special meeting of the stockholders was held on June 7, 1951. The minutes of that meeting state in part as follows (R. 263):

The President announced that the sole purpose for the meeting was the discussion of the proposed method of partial liquidation of the corporation's assets by distributing the merchandising business to stockholders in exchange for 8,000 shares of stock.

Under the plan, a shareholder would receive a 1/8000 interest in the mercantile business for each share of stock surrendered. (R. 268.)

The stockholders approved the plan by a resolution which stated that the purpose was "to effect a division and segregation of the operation, management and maintenance of the real properties of the corporation from the ownership, operation, management



and control of the merchandising business of the corporation.” (R. 263.)

Pursuant to the execution of the plan, an escrow agent was selected to receive stock from those who elected to surrender their shares. An escrow account was opened on July 2, 1951. (R. 265.) This escrow continued until October, 1951, when the distribution of the mercantile business was made and the lease of taxpayer’s property was executed. While the escrow was pending, McEnery and Benson acquired more shares of stock raising their total holdings to 6,963 shares (34.3%) and 8,231 shares (41.1%), respectively, giving them a combined holding of 75.4% of the outstanding stock. (R. 266, 268–269.)

McEnery testified that during the life of the escrow account, stockholders would deposit shares and then change their minds and remove them, and other shareholders would deposit shares to take the place of those removed. The stock in escrow was thus in a state of flux. (R. 83, 86.) The flux continued until about October 1, 1951, at which time there remained seven shareholders who had elected to surrender all or part of their stock.<sup>3</sup> On October 19, 1951, these seven persons executed an agreement forming a partnership to operate the hardware business. The hardware business was not transferred from taxpayer to the partnership until after the execution of that agreement. (R. 266, 268–269.)

After the partnership was formed, it executed a 20-year lease of the ground floor of taxpayer’s build-

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<sup>3</sup> Four members of this group surrendered all of their stock and the other three surrendered only part. (R. 266.)



ing at an annual rent of \$18,000. Under the escrow agent's instructions from Kirby, taxpayer's attorney and secretary, the hardware business could not be turned over to the partnership until (1) the lease had been executed and recorded, (2) taxpayer had received \$18,000 representing the rent for the last year on the lease, and (3) the 8,000 shares of stock were received. This was performed by October 24, 1951, and on that date, the escrow agent delivered a bill of sale to the partnership.<sup>4</sup> (R. 268.)

Benson and McEnery were members of that partnership and surrendered 3,753 and 3,754 shares respectively. Thus, their combined interests accounted for more than 93% of the partnership. Also, they retained 4,478 and 3,209 shares respectively, amounting to 64% of taxpayer's outstanding stock. (R. 266-267.)

At the regular meeting of the board of directors on August 16, 1961, taxpayer's accountant noted that in a submitted financial statement, he had reduced the stated capital of taxpayer from \$200,000 to \$120,000. The directors accordingly adopted a resolution reducing taxpayer's stated capital to \$120,000 represented by 12,000 shares of stock at \$10 par. This was expressly ratified by the shareholders at their annual meeting on February 13, 1952. (R. 273.) Thus, the surrendered stock was retired. (R. 290.)

In its return for 1951, taxpayer treated this transaction as a sale and reported a loss of \$226,349.84 therefrom. It computed this loss by deducting from

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<sup>4</sup>The bill of sale was dated October 19, 1951, but was not even delivered to the escrow agent until October 23. (R. 271.)

the adjusted basis of the transferred assets (\$306,349.84) the par value of the 8,000 shares of surrendered stock (\$80,000). (R. 278.) Taxpayer reported a total loss of \$246,952.11 in that year.<sup>5</sup> In its returns for 1952 and 1953, taxpayer reported net income of \$16,544.54 and \$26,982.20, respectively, which it claimed was discharged by carrying over the net operating loss from 1951. The Commissioner determined that taxpayer had no recognizable loss in 1951 and therefore disallowed the claimed carry-over deduction. (R. 276.) In addition, the Commissioner determined that taxpayer had a net profit rather than a loss in 1951. (R. 277.)

In connection with the transaction, taxpayer expended \$450 in 1951 and \$1,650.50 in 1952 for legal and accounting fees. Taxpayer deducted those items as business expenses and the Commissioner disallowed them on the ground that they were nondeductible capital expenses. (R. 275.)

Taxpayer brought this action for a redetermination of the Commissioner's decision concerning the distribution of the mercantile business to the partnership and the expenditures for legal and accounting fees.<sup>6</sup> The Tax Court sustained the Commissioner on both issues. (R. 254-295.)

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<sup>5</sup> Of that amount, \$217,527.20 was represented as a loss from sales. (R. 275.)

<sup>6</sup> There were originally two other issues in this case, but they were conceded below, one by taxpayer and one by the Commissioner.



## SUMMARY OF ARGUMENT

1. Taxpayer contends that it had a net loss deduction in 1951 with a resulting carry-over for subsequent years. This loss allegedly arose as a result of a distribution of taxpayer's mercantile business in exchange for 8,000 shares of its capital stock. While a sale of assets by a corporation for its own stock is a taxable transaction to it, a partial liquidation is not. Whether a distribution in kind is a sale or a liquidation is a question of fact turning upon the particular circumstances of the case. In this case, the court below found that the distribution in kind with the resulting contraction of taxpayer's business was a partial liquidation and, therefore, no gain or loss could be realized by the taxpayer therefrom. That finding is supported by substantial evidence.

Moreover, even if the transaction were a sale, taxpayer did not realize a loss therefrom. The distribution in kind was made to a partnership, two members of which controlled 64 per cent of the taxpayer's outstanding stock. Under the constructive ownership provisions of Section 24(b)(2) of the Internal Revenue Code of 1939, each member of the partnership is deemed to own over 50 per cent of the taxpayer's stock and, therefore, Section 24(b)(1) prohibits the recognition of loss in this transaction.

Also, taxpayer failed to demonstrate the fair market value of the shares of stock that were surrendered in exchange for the mercantile business. It merely valued them at par. Taxpayer, therefore, failed to meet its burden of proof on that question.



2. Taxpayer also contends that expenditures for certain legal and accounting expenses incident to the transaction here involved were improperly disallowed by the court below as capital expenses. As taxpayer indicated, the resolution of this issue was consistent with the court's determination that the distribution of the mercantile business was a partial liquidation rather than a sale.

#### ARGUMENT

#### **I. The distribution of taxpayer's mercantile business in exchange for capital stock was a partial liquidation rather than a sale and, therefore, no gain or loss was realized thereby**

In October, 1951, taxpayer transferred the assets of its mercantile business to a partnership in return for 8,000 shares of its capital stock. (R. 268-269.) Taxpayer treated the transaction as a sale on its federal tax returns and reported a loss therefrom of \$226,349.84. Taxpayer computed this loss by deducting the par value of the transferred stock (\$80,000) from the adjusted basis of the assets given in exchange (\$306,349.84). (R. 278.)

Treasury Regulations 111 (1939 Code), Section 29.22(a)-15 (Appendix, *infra*), provide that where a corporation acquires its own shares as consideration for the sale of assets, the resulting gain or loss is recognized. However, Section 29.22(a)-20 (Appendix, *infra*) provides that "No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however, they may have appreciated or depreciated in value since their acquisition." See, *Dill Manufacturing Co. v. Commissioner*, 39 B.T.A. 1023. The ques-

tion of whether an exchange of a corporation's assets for its stock is a sale or a partial liquidation "depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances." Treasury Regulations 111 (1939 Code), Sec. 29.22(a)-15. See, *Commissioner v. S. A. Woods Mach. Co.*, 57 F. 2d 635, 636 (C.A. 1st), reversing, 21 B.T.A. 818, certiorari denied, 287 U.S. 613.

Thus, the primary issue in this action (*viz.*, whether the exchange of the mercantile business for the capital stock was a partial liquidation rather than a sale) is a factual question. Cf., *Earle v. Woodlaw*, 245 F. 2d 119, 126 (C.A. 9th), certiorari denied, 354 U.S. 942. The Tax Court found that the transaction was a partial liquidation and, consequently, that taxpayer did not realize a loss therefrom. As we now show, that finding is amply supported by the evidence and, therefore, is unassailable on review, *Commissioner v. Court Holding Co.*, 324 U.S. 331, 333-334; *Helvering v. Rankin*, 295 U.S. 123, 131; *Commissioner v. Duberstein*, 363 U.S. 278, 291; *Grace Bros. v. Commissioner*, 173 F. 2d 170, 173-174 (C.A. 9th).

#### A. The evidence supports the decision of the Tax Court

The purpose of the distribution in kind here involved was to segregate the mercantile business from the real property business. (R. 263.) Taxpayer's officers had first considered selling the mercantile business but never executed that plan. In 1950, taxpayer's directors proposed that the segregation be effected by a corporate "spin-off"—i.e., by forming a new corporation and transferring the real estate business thereto in exchange for stock which was to be dis-



tributed to taxpayer's shareholders. That plan was also abandoned, apparently for tax reasons. (R. 65, 260-262.)

Finally, in May, 1951, taxpayer's president, McEnergy, suggested to the directors the plan that was ultimately adopted and is here involved. McEnergy first described that plan as "a sale of some of the assets of the corporation to the stockholders in exchange for the capital stock." (R. 262.) However, McEnergy later described it at a subsequent stockholders meeting as a "*partial liquidation* of the corporation's assets by distributing the merchandising business to stockholders in exchange for 8,000 shares of stock." [Emphasis added.] (R. 263.) Also, the shareholders adopted a resolution at that meeting approving the proposed plan in terms which indicate that a purchase-sale transaction was not contemplated. (R. 289.)

At the trial, McEnergy was asked why the number of shares to be surrendered was fixed at the figure 8,000. McEnergy testified that the mercantile business was worth two-fifths of the corporation's total business and that the real estate business was worth three-fifths. The number of shares to be surrendered was therefore fixed at 8,000, i.e., two-fifths of the outstanding capital stock, which was then 20,000 shares. (R. 109-110.) In other words, taxpayer exchanged two-fifths in value of its assets for two-fifths of its outstanding stock.<sup>7</sup>

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<sup>7</sup> The following colloquy, which occurred during the cross-examination of McEnergy, dispels any doubt concerning the equality of the exchange (R. 109-110):



The result and purpose of the transaction was to contract the business of taxpayer by eliminating its mercantile activities. Contraction of business is one of the basic elements of a partial liquidation. E.g., *Earle v. Woodlaw*, 245 F. 2d 119, 126 (C.A. 9th), certiorari denied, 354 U.S. 942; *Pacific Vegetable Oil Corp. v. Commissioner*, 251 F. 2d 682, 685 (C.A. 9th); *Imler v. Commissioner*, 11 T.C. 836, 841. Indeed, in *Weinman v. Commissioner*, decided October 15, 1956 (1956 P-H T.C. Memorandum Decisions, par. 56,229), the Tax Court indicated that contraction is the very essence of a partial liquidation. The court said:

Without more, it would seem that a business, which for adequate reasons eliminates part of its operations and in the process rids itself of

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“Q. How did you arrive at this figure of 8,000 shares?

“A. I didn’t arrive at that. It was arrived at by various discussions, and so forth, with the accountant, as to what would be somewheres near an equal apportionment. That was me, with the accountant.

“The COURT. Well, you still haven’t answered the question. What we want to know is: Why did you conclude that 8,000 shares would be the number of shares to be surrendered in exchange for the inventory of the mercantile business?

“The WITNESS. I think if you put the mercantile business at anywheres near the value it should have been and put the real estate at anywheres near the value it should have been, it should be about three-fifths to two-fifths.

“The COURT. Which?

“The WITNESS. Two-fifths for the business and three-fifths for the real estate.

“Q. (by Mr. MUNTER). In what you had attempted to work out in this 8,000 to 12,000——

“The COURT. 8,000 is supposed to be two-fifths of 20,000, is that the idea?

“The WITNESS. Yes, Ma’am.”

property no longer useful in those operations, has engaged in a partial liquidation in the most direct sense.

The term "partial liquidation" is defined in Section 346 of the Internal Revenue Code of 1954 (26 U.S.C. 1958 ed., Sec. 346). In discussing that section prior to its enactment, the Senate Report (S. Rep. No. 1622, 83d Cong., 2d Sess., p. 262 (3 U.S.C. Cong. & Adm. News (1954) 4621, 4899)) stated:

Primarily, this definition involves the concept of "corporate contraction" *as developed under existing law.* \* \* \*.

It is intended that a genuine contraction of business *as under present law* will result in partial liquidation. [Emphasis added.]

After the distribution of the mercantile business with the resulting contraction of taxpayer's business, the stated capital of taxpayer was reduced from \$200,000, represented by 20,000 shares of stock at \$10 par, to \$120,000 represented by 12,000 shares. (R. 273.) Thus, the 8,000 shares which had been redeemed from the partnership were retired and were no longer outstanding. (R. 290.)

Taxpayer apparently disputes this last finding (Br. 29) and contends that the 8,000 shares were not retired but were restored "to the status of authorized but unissued shares." It is noteworthy that in the court below, taxpayer asserted in its opinion brief (p. 14) that the shares were retired when the stated capital was reduced but repudiated that assertion in its reply brief (p. 6). In any case, the reduction of stated capital infers that the shares were retired.



In the absence of evidence to the contrary, the finding of the Tax Court on that question must, therefore, be sustained. E.g., *Commissioner v. Court Holding Co.*, 324 U.S. 331, 333–334; *Commissioner v. Duberstein*, 363 U.S. 278, 291.

Moreover, even if taxpayer were correct, the difference between retired stock and stock restored to the authorized but unissued status is not sufficient to alter the tax consequences of this transaction. In either event, the redemption of the shares with the resulting reduction of stated capital constituted a change in the capital structure of the business, and it is that change which is most significant here. Section 115(i) of the Internal Revenue Code of 1939 (Appendix, *infra*) defines a partial liquidation as a “distribution by a corporation in complete cancellation *or* redemption of a part of its stock” [emphasis added]. The statute requires either retirement or redemption, and those terms are not synonymous. The term “retirement” includes redemption but is a much broader term.<sup>8</sup> *McClain v. Commissioner*, 311 U.S. 527, 530. Consequently, it is not necessary that the stock be actually retired for a partial liquidation to exist. That is particularly true here where apparently California law makes no distinction between retired stock and stock which is restored to the status of authorized and unissued. See, Section 1714 of the California Corporations Code (Appendix, *infra*), which states that “Unless the articles provide other-

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<sup>8</sup> The word “redeem” is defined in Webster’s International Dictionary (2d ed.) as, *inter alia*, to repurchase or to regain possession by purchase.



wise, treasury shares may be retired and restored to the status of authorized and unissued shares.”

After the distribution, the mercantile business was controlled by the same two persons (McEnery and Benson) who controlled taxpayer before that transaction. They owned more than 93% of the partnership and 64% of the taxpayer's outstanding stock. (R. 266-267.)

In sum, the emerging factual picture clearly points to a partial liquidation rather than a sale. The transaction here involved was executed in order to segregate taxpayer's mercantile business from its real estate business. It was necessary to distribute the mercantile business in exchange for stock because of the tax consequences then attendant to a corporate spin-off. As taxpayer's officers were acutely aware of possible tax consequences, they attempted to cloak the liquidation in the guise of a sale so that the corporation could realize a net loss deduction, part of which might be carried five years forward. Sec. 122, Internal Revenue Code of 1939 (26 U.S.C. 1952 ed., Sec. 122). However, the officers did not always adhere to the label they had attached to this transaction. In the minutes of the director's meeting of June 7, 1951, McEnery is quoted as describing the transaction as a partial liquidation. (R. 263.) Also, as the court below noted (R. 289-290), taxpayer apparently failed to comply with the Bulk Sales Act of California. The significance of this omission is that it lends further weight to the inference that

even taxpayer's officers and attorney did not consider this transaction as a sale.<sup>9</sup>

Of greater importance, however, is that the purpose and result of the distribution was a contraction of taxpayer's business. The taxpayer exchanged its mercantile business, representing two-fifths of its total corporate value, for 8,000 shares of stock (i.e., two-fifths of its stock). Taxpayer's business was contracted; its assets were reduced; its stated capital was reduced; and the surrendered stock was retired. The net effect of the transaction was that while the same two persons continued to control both the mercantile and the real estate business, the taxpayer's business had been contracted so that its realty holdings were no longer subject to the risk of the mercantile business, and the amount of stock redeemed was in exact proportion to the relative value of the assets distributed (i.e., two-fifths of the assets in exchange for two-fifths of the stock.)

Thus, there is substantial and convincing evidence to support the decision of the Tax Court which should, therefore, be sustained. E.g., *Commissioner v. Court Holding Co.*, *supra*; and *Commissioner v. Duberstein*, *supra*.

**B. The decision of the Tax Court is consistent with the cases which have considered the issue here involved**

Taxpayer asserts (Br. 26-28) that the decision below is inconsistent with the decisions of several circuit

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<sup>9</sup> As taxpayer observed in its opening brief below (p. 16), its attorney at that time had a fine local reputation. It is unlikely, therefore, that he would have failed to comply with the Bulk Sales Act if he believed the transaction to be a sale.



court cases. For a proper consideration, these cases should be viewed in the perspective of the development of the case law pertaining to the tax consequences of a corporation's dealing in its own stock.

Prior to 1930, there was a split of authority as to whether a corporation could in any circumstances realize a gain or loss on the acquisition of its own common stock. 7 Mertens, *Law of Federal Income Taxation* (1957 ed.) Sec. 38.29. In that year, the entire court of the Board of Tax Appeals considered the matter and determined that no gain or loss was realized irrespective of whether the stock was acquired by purchase or redemption in liquidation. *Houston Brothers Co. v. Commissioner*, 21 B.T.A. 804. Two years later, the First Circuit held that a gain was recognized where a corporation purchased its own stock and, accordingly, reversed the decision of the Board of Tax Appeals to the contrary. *Commissioner v. S. A. Woods Mach. Co.*, 57 F. 2d 635, reversing 21 B.T.A. 818, certiorari denied, 287 U.S. 613. The court held that the taxpayer in that case was dealing in its own stock as it might in that of another company. The issue involved was whether a corporation could realize a gain in those circumstances, and no issue was raised or considered as to whether the transaction was a partial liquidation.

Also, in *Commissioner v. Boca Ceiga Development Co.*, 66 F. 2d 1004 (C.A. 3d), it was assumed that the transaction was a sale, and the question presented was whether a corporation's purchase of its stock could result in a taxable transaction to it. Again, there was no contention made that the transaction was



a liquidation. Similarly, see *Allyne-Zerk Co. v. Commissioner*, 83 F. 2d 525 (C.A. 6th); *Dorsey Co. v. Commissioner*, 76 F. 2d 339 (C.A. 5th), certiorari denied, 296 U.S. 589; and *Trinity Corp. v. Commissioner*, 127 F. 2d 604 (C.A. 5th), certiorari denied, 317 U.S. 651.

All of those cases turned upon the particular facts there involved and do not control this case. However, it is significant that the question of whether there was a partial liquidation was not argued or considered there. As the Supreme Court stated in *Webster v. Fall*, 266 U.S. 507, 511:

The most that can be said is that the point was in the cases if anyone had seen fit to raise it. Questions which merely lurk in the record, neither brought to the attention of the court nor relied upon, are not to be considered as having been so decided as to constitute precedents.

The sole appellate decision cited by taxpayer which actually considered the question here involved was *Hammond Iron Co. v. Commissioner*, 122 F. 2d 4 (C.A. 5th). In that case, the corporation purchased the outstanding preferred and common shares of a stockholder and claimed a loss on the transaction. The Commissioner disallowed the deduction and contended in the notice of deficiency that the transaction was actually a partial liquidation. The Board of Tax Appeals decided for the Commissioner on a different ground. On review, the Commissioner did not urge that the transaction was a partial liquidation but argued only in support of the reasons given by the lower court.

The Fifth Circuit nevertheless passed upon that issue and held that the evidence did not indicate a liquidation. However, the evidence in this case does so indicate. It is noteworthy that in *Hammond Iron, Trinity Corp., Dorsey Co., Boca Ceiga, and Allyne-Zerk*, common stock was only a part of the consideration paid to the corporation for its assets. See also, *Johnson-McReynolds Chevrolet Corp. v. Commissioner*, 27 T.C. 300. The existence of additional consideration would indicate a sale. In the *S. A. Woods* case, the stock was accepted in settlement of liquidated damages and, consequently, there was no business contraction there. Those facts are in contrast with the facts of the instant case where only the taxpayer's stock was exchanged and there was a contraction of business.

On the other hand, there are numerous cases holding that such transactions are partial liquidations. E.g., *Lucius Pitkin, Inc. v. Commissioner*, 13 T.C. 547; *Fox v. Commissioner*, decided June 30, 1939 (1939 P-H B.T.A. Memorandum Decisions, par. 39,325), affirmed *per curium*, 113 F. 2d 113 (C.A. 3d); *Dill Manufacturing Co. v. Commissioner*, 39 B.T.A. 1023. While these cases are relevant, as the Regulations provide,<sup>10</sup> it is the particular factual circumstances of each case that control. As demonstrated in Point A above, the evidence in this case supports the decision below.

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<sup>10</sup> Treasury Regulations 111 (1939 Code) Sec. 29.22(a)-15. See also, *Commissioner v. S. A. Woods Mach. Co.*, *supra*, 57 F. 2d, p. 636.



**II. The Tax Court properly determined that certain expenditures of taxpayer for legal and accounting services incident to the distribution in partial liquidation were capital expenses and, therefore, are not deductible**

In connection with the transaction here involved, taxpayer expended \$450 in 1951 and \$1,650.50 in 1952 for legal and accounting services. (R. 275.) Taxpayer seeks deductions for those items as business expenses. As the expenditures were incurred pursuant to the execution of the plan of liquidation, the expenses must be capitalized and may not be deducted as ordinary expenses. *Mills Estate v. Commissioner*, 206 F. 2d 244 (C.A. 2d); *Standard Linen Service, Inc. v. Commissioner*, 33 T.C. 1, 17.

Taxpayer apparently concedes (Br. 38) that the decision of the court below on this issue is a proper consequence of the court's decision that the transaction was a liquidation. Taxpayer contends only that if this Court reverses the Tax Court and holds that the transaction was a sale, then the decision on this question should also be reversed. We agree with the taxpayer that the resolution of this question turns upon the resolution of the primary issue in this case.<sup>11</sup>

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<sup>11</sup> However, we note that while this question is closely interrelated with the primary issue on review, taxpayer did not mention it in its petition for review (R. 300-301) which taxpayer adopted as its statement of points to be urged on review. Consequently, the Court may wish to consider whether under its rules (Rule 17(6)) this question should be reviewed here. See, *Bank of America Nat. T. & Sav. Ass'n v. Commissioner*, 126 F. 2d 48, 52 (C.A. 9th).



**III. Even if taxpayer's distribution of the mercantile business were a sale rather than a partial liquidation, taxpayer would nevertheless have no recognizable loss from the transaction**

As previously stated, the primary issue on review is whether taxpayer's distribution of the mercantile business is a liquidation or a sale. The court below found and the Commissioner contends that it was a liquidation in which there can be no loss to the corporation. However, even if taxpayer were correct in asserting that the transaction was a sale, it would, nevertheless, have no recognizable loss therefrom.

**A. No loss is allowable on this transaction because the distributees of taxpayer's mercantile business owned more than 50 percent of its outstanding stock**

Section 24(b) of the Internal Revenue Code of 1939 (Appendix, *infra*), "prohibits any deduction, in computing net income, for losses from sales or exchanges of property—except in the case of distributions in liquidation—between an individual and a corporation whose stock is more than 50 percent owned by or for him." *Commissioner v. Whitney*, 169 F. 2d 562, 564, certiorari denied, 355 U.S. 892. This prohibition is equally applicable where the sale or exchange is between a corporation and a partnership whose members own together more than 50 per cent of the corporations outstanding stock. *Commissioner v. Whitney*, *supra*. Treasury Regulations 111 (1939 Code), Sec. 29.24-6(c) and (d) (Appendix, *infra*). That is so because of the provision for constructive ownership of stock in Section 24(b) (2) of the Code.

The mercantile business was not transferred by taxpayer until after the formation of the partnership<sup>12</sup> and was transferred to the partnership. (R. 269.) Two of the partners (McEnery and Benson) owned more than 50% of the outstanding stock of taxpayer after the distribution. (R. 267.) Those same two men owned more than 93% of the partnership. (R. 266.) By operation of the constructive ownership provisions in Section 24(b)(2), each of the seven partners is deemed to own more than 50% of the outstanding stock of taxpayer. Consequently, the mercantile business was transferred to persons owning

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<sup>12</sup> That finding is amply supported by the evidence. The escrow account was opened on July 2, 1951. (R. 265.) During the life of the escrow account, stockholders would deposit shares and then change their minds and remove them. The stock in escrow was thus in a state of flux. (R. 83, 86.) The flux continued until about October 1, 1951, at which time there remained seven shareholders who had elected to surrender stock. On October 19, 1951, those seven persons formed a partnership to operate the business. (R. 269.)

After the partnership was formed, it executed a 20-year lease of the ground floor of taxpayer's building for \$18,000 per year. (R. 272.) The escrow agent was instructed by Kirby, taxpayer's attorney and secretary, not to turn over the mercantile business until: (1) the lease had been executed and recorded, (2) taxpayer had received \$18,000 representing the rent for the last year on the lease, and (3) the 8,000 shares of stock were received. (R. 268.) It is clear that there could be no exchange until those conditions had been met. That occurred on October 24, 1951 (five days after the formation of the partnership) and on that date, the escrow agent delivered the bill of sale to the partnership. (R. 268.)

Also, it is noteworthy that the partnership agreement (Ex. 4-D) states that the parties thereto surrendered the 8,000 shares "concurrently with the execution of [the] partnership agreement."



more than 50% of taxpayer's stock, and no loss could be realized on the transaction. Sec. 24(b)(1) of the Internal Revenue Code of 1939. E.g., *Commissioner v. Whitney, supra*.

The Commissioner raised this question in the court below as an alternative contention. In view of the Tax Court's resolution of the primary issue here involved, the court considered it unnecessary to consider this question. (R. 293.)

**B. Taxpayer failed to demonstrate that it suffered any actual loss on the transaction**

Finally, taxpayer failed to demonstrate in the court below that, in fact, it suffered any loss on this transaction even if it were a sale. The amount of gain or loss on the purchase of stock is computed on the basis of the fair market value of the stock as compared with the adjusted basis of the assets. Cf., *Dorsey Co. v. Commissioner*, 76 F. 2d 339 (C.A. 5th), certiorari denied, 286 U.S. 589. Taxpayer had the burden of demonstrating the market value of the stock surrendered to it. See, *Burnet v. Houston*, 283 U.S. 223.

Taxpayer computed its alleged loss on the premise that the value of the stock was par, viz., \$10 per share.<sup>13</sup> (R. 278.) Thus, taxpayer contends that in transferring two-fifths of its assets for two-fifths of its own stock, it suffered a loss of over \$226,000. (R.

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<sup>13</sup> There is no evidence in the record to substantiate that evaluation. The sole testimony concerning the value of the stock was the statement of McEnery that he purchased "a few shares" during this period for "around \* \* \* \$15.00 a share." (R. 130.) Such testimony of only one transaction with one person concerning a few shares is hardly adequate to warrant a finding concerning the fair market value of the stock.



278.) In view of the obvious equality of value between the stock and the transferred assets, the contention that the stock was worth only \$80,000 is palpably erroneous, and taxpayer failed to demonstrate any actual loss on the exchange.

**C. No loss carry-over is allowable**

The court below also held alternatively that even if taxpayer sustained a loss on a sale, there could be no carry-over to subsequent years. (R. 286.) See, *Dalton v. Bowers*, 287 U.S. 404; *Libson Shops v. Koehler*, 353 U.S. 382. As the transaction involved was not a sale and even if it were taxpayer did not realize a loss therefrom, it is not necessary for the Court to reach this question.

**CONCLUSION**

For the foregoing reasons, we respectfully submit that the decision of the Tax Court should be affirmed.

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OCTOBER, 1961.

## APPENDIX

### Internal Revenue Code of 1939:

#### SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly.

\* \* \* \* \*

(26 U.S.C. 1952 ed., Sec. 22.)

#### SEC. 24. ITEMS NOT DEDUCTIBLE.

\* \* \* \* \*

(b) *Losses from Sales or Exchanges of Property.*—

(1) *Losses disallowed.*—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

(A) Between members of a family, as defined in paragraph (2)(D);

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of

the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(D) Between a grantor and a fiduciary of any trust;

(E) Between the fiduciary of a trust and the fiduciary of another trust, if the same person is a grantor with respect to each trust; or

(F) Between a fiduciary of a trust and a beneficiary of such trust.

(2) *Stock ownership, family, and partnership rule.*—For the purposes of determining, in applying paragraph (1), the ownership of stock—

(A) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(B) An individual shall be considered as owning the stock owned directly or indirectly, by or for his family;

(C) An individual owning (otherwise than by the application of subparagraph (B)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(D) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(E) *Constructive ownership as actual ownership.*—Stock constructively owned by a person



by reason of the application of subparagraph (A) shall, for the purpose of applying subparagraph (A), (B), or (C), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of subparagraph (B) or (C) shall not be treated as owned by him for the purpose of again applying either of such subparagraphs in order to make another the constructive owner of such stock.

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(26 U.S.C. 1952 ed., Sec. 24.)

#### SEC. 115. DISTRIBUTION BY CORPORATIONS.

\* \* \* \* \*

(i) *Definition of Partial Liquidation.*—As used in this section the term “amounts distributed in partial liquidation” means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

\* \* \* \* \*

(26 U.S.C. 1952 ed., Sec. 115.)

Treasury Regulations 111 (1939 Code):

SEC. 29.22(a)-15. *Acquisition or Disposition by a Corporation of Its Own Capital Stock.*—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

But if a corporation deals in its own shares as it might in the shares of another corpora-

tion, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code.

SEC. 29.22(a)-20. *Gross Income of Corporation in Liquidation*.—When a corporation is dissolved, its affairs are usually wound up by a receiver or trustees in dissolution. The corporate existence is continued for the purpose of liquidating the assets and paying the debts, and such receiver or trustees stand in the stead of the corporation for such purposes. (See sections 274 and 298.) Any sales of property by them are to be treated as if made by the corporation for the purpose of ascertaining the gain or loss. No gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition. But see section 44(d) and section 29.44-5. (See further section 29.52-2.)

SEC. 29.24-6. *Losses from Sales or Exchanges Between Certain Classes of Persons*.—\* \* \*

(b) *Corporations (including shareholders)*.—In the case of sales or exchanges of property (except in the case of distributions in liquidation) where a corporation not acting in a fiduciary capacity is a party to the transaction, section 24(b)(1) also provides that under certain circumstances no deduction shall be allowed with respect to losses arising from such sales or exchanges, directly or indirectly, between a corporation and an individual share-



holder (see section 24(b)(1)(B)) or between two corporations (see section 24(b)(1)(C)). Under section 24(b)(1)(B) it is necessary that there be owned, directly or indirectly, by or for the individual a party to the transaction, more than 50 percent in value of the stock of the other party to the transaction on the date of the sale or exchange. \* \* \*

\* \* \* \* \*

(d) *Illustrations of the application of section 24(b).*—The application of section 24(b) may be illustrated by the following examples:

\* \* \* \* \*

*Example (2).* On June 15, 1942, all of the stock of the N Corporation was owned in equal proportions by A and A's partner, AP. Except in the case of distributions in complete or partial liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1942, between A and the N Corporation or AP and the N Corporation inasmuch as, by the application of section 24(b)(2)(C), each partner is considered as having owned the stock owned by the other and, therefore, is considered as having owned more than 50 percent in value of the outstanding stock of the N Corporation. Deductions for losses from sales or exchanges between A's brother, AB, and the N Corporation, or between AP and A, or AP and AB are not prohibited by section 24(b).

California Corporations Code, 24 West's Annotated California Codes:

§ 1714. *Treasury shares.* Treasury shares shall not carry voting or dividend rights and shall not be counted as outstanding shares for any purpose, nor as assets for the purpose of computing a surplus available for dividends or the purchase of shares issued by the corporation or the making of any other distributions to its shareholders. Unless the articles provide other-



wise, treasury shares may be retired and restored to the status of authorized and unissued shares without reduction of stated capital or may be disposed of for such consideration as the board of directors may fix. If the shares are reissued, the amount of the proceeds shall be attributed to paid-in surplus insofar as an excess of net assets over the amount of stated capital results therefrom.

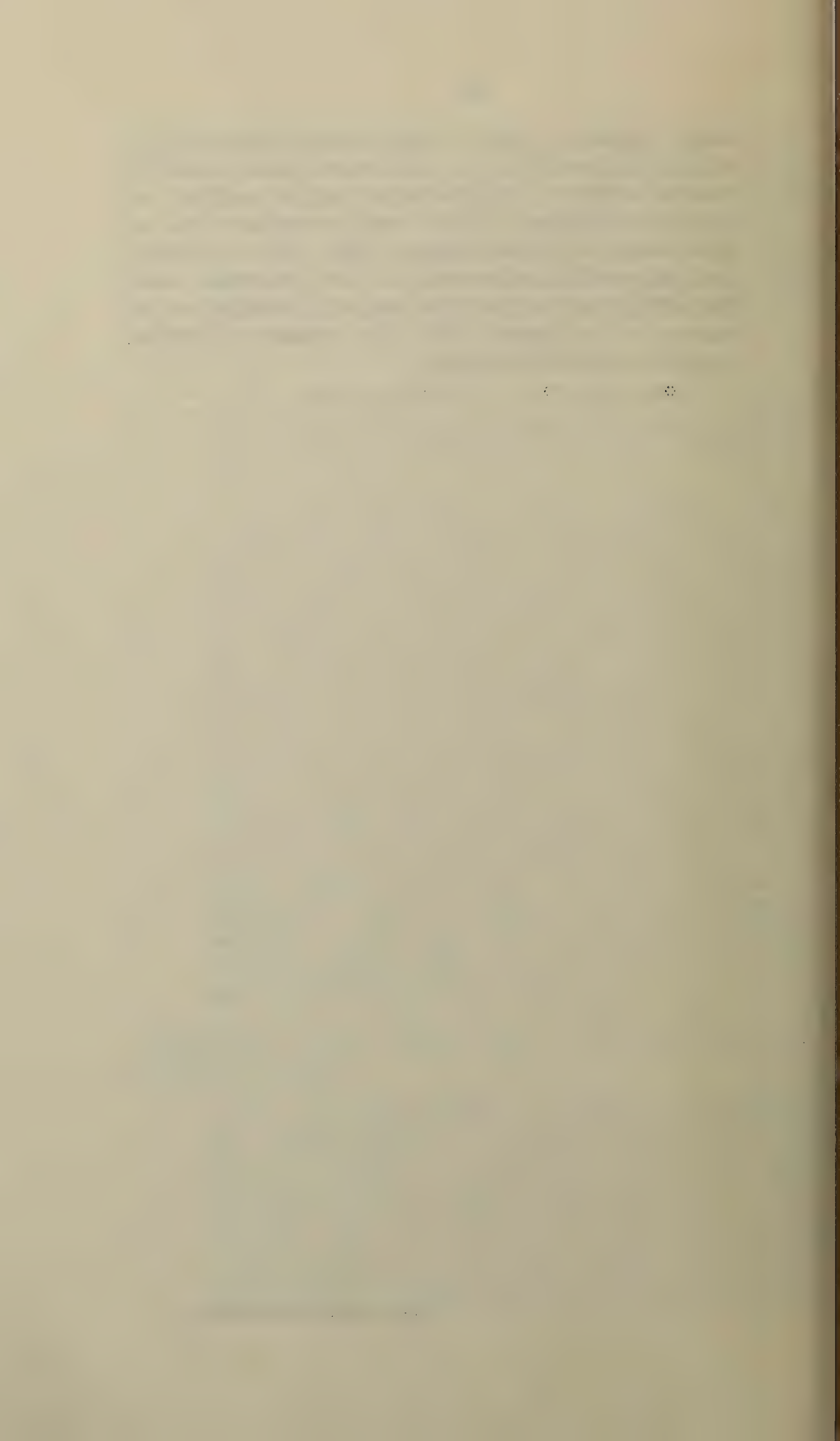
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No. 17,352

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

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FARMERS UNION CORPORATION,  
*Petitioner,*

VS.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

---

On Petition for Review of the Decision of the  
Tax Court of the United States

REPLY BRIEF FOR PETITIONER

---

RALPH A. YEO,  
3404 Fernwood Avenue,  
San Mateo, California,  
*Attorney for Petitioner.*

FILED

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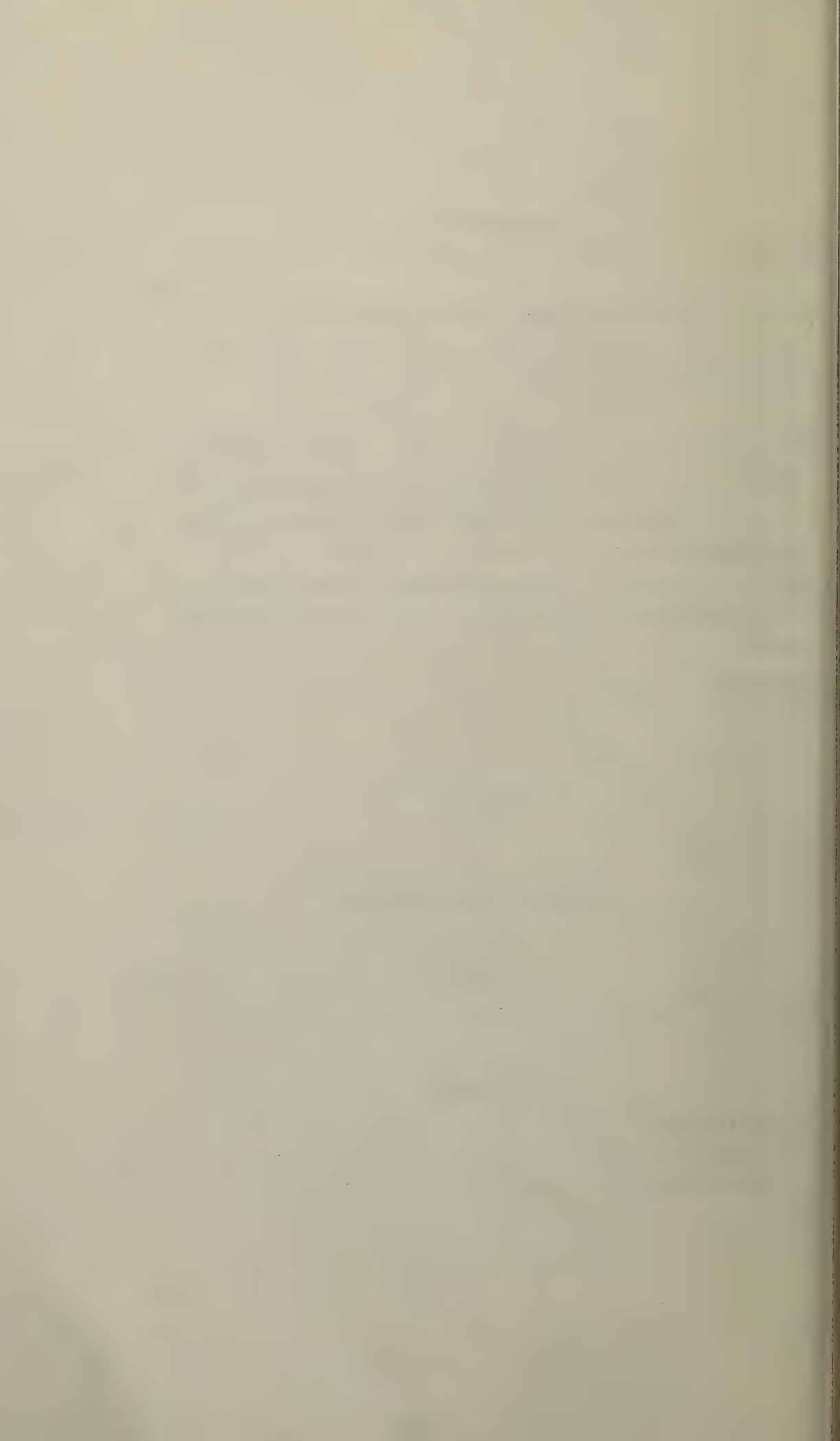
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FARMERS UNION CORPORATION,

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On Petition for Review of the Decision of the  
Tax Court of the United States

**REPLY BRIEF FOR PETITIONER**

---

REPLY TO ARGUMENT OF RESPONDENT THAT THE DISTRIBUTION OF TAXPAYER'S MERCANTILE BUSINESS IN EXCHANGE FOR CAPITAL STOCK WAS A PARTIAL LIQUIDATION RATHER THAN A SALE, AND, THEREFORE, NO GAIN OR LOSS WAS REALIZED THEREBY.

The brief for respondent, generally paraphrases the decision of the Tax Court on this point, with additional emphasis upon one of the minutes of petitioner that used the word "liquidation" and reliance upon the doctrine of "business contraction" as evidence of the exchange in question being a partial liquidation.

In extension of the argument of petitioner in its opening brief, it may be noted (1) that other minutes of the petitioner contained the words "sale" and

“segregation by sale”; (2) that notification to the stockholders of the plan adopted by the board of directors was accompanied by an “offer” to exchange corporation property for stock; and (3) that financial statement, issued concurrently, contained a list describing and evaluating the items “to be sold”. These facts, when added to the substantial evidence of intent of the petitioner to sell some of its assets, rather than to engage in a “mere distribution of its assets in kind in partial or complete liquidation . . .” (Section 22(a)-20, I. R. C., 1939) would tend to reduce the significance of respondent’s contention in this regard.

Respondent cites no authority to support his conclusion that contraction of business, as a result of any transaction, would require that such transaction be identified as a partial liquidation, under the 1939 Internal Revenue Code.

Respondent argues that reduction of stated capital and cancellation or retirement of the stock acquired by petitioner are additional reasons for concluding that the subject transaction was a distribution in liquidation. There is no evidence that the stock, so acquired, was cancelled or retired or that it was negotiated and obtained for that purpose. Accordingly, the capital structure of the petitioner remained the same. (See statutes and cases cited in petitioner’s opening brief.)

The preponderance of the evidence in the record firmly establishes this transaction as a negotiated sale of specified corporation property in which the stock involved was received as consideration therefor.



REPLY TO ARGUMENT OF RESPONDENT THAT EVEN IF TAXPAYER'S DISTRIBUTION OF THE MERCANTILE BUSINESS WERE A SALE, NO LOSS IS ALLOWABLE ON THIS TRANSACTION BECAUSE THE DISTRIBUTEES OF TAXPAYER'S PROPERTY OWNED MORE THAN 50 PERCENT OF ITS OUTSTANDING STOCK.

On September 17, 1958, approximately three weeks before trial, respondent served an amendment to answer in which it was alleged that if the sale alleged in the petition did, in fact, occur, petitioner would still not be entitled to a loss deduction because of the provisions of Section 24(b) and 24(b)(2)(c) of the Internal Revenue Code of 1939 (R. 9-10).

At the outset of the trial, during the opening statement for petitioner, the alternative or conflicting issues were called to the attention of the Court. After some colloquy, the Court agreed that respondent would be required to elect to prove either that the transaction was a distribution in liquidation and not a sale or concede that there was a sale but to a related interest, under 24(b), I. R. C. (1939) (R. 19-21).

At no time, during the trial, was the question of possible sale to a related interest at issue. No documentary evidence was introduced in proffered proof of such a sale and the only testimony, that had any bearing on the subject, was given by Mr. McEnery (R. 84-88) and Mr. Benson (R. 157-158) who, on direct examination, described their separate and unrelated actions in acquiring their respective interests in the property offered by the corporation.

No mention was made of the subject in the decision of the Tax Court, except to state that the conclusion



reached made it “unnecessary to consider other arguments and related questions which have been presented by both parties” (R. 293). Accordingly, it is respectfully submitted that there is no issue or decision of the Tax Court involving the application of the aforesaid Section 24(b), that can properly be made the subject of review by or appeal to this Circuit Court of Appeals. *Rhodes*, 111 F. 2d 53.

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**REPLY TO ARGUMENT OF RESPONDENT THAT TAXPAYER  
FAILED TO DEMONSTRATE THAT IT SUFFERED ANY  
ACTUAL LOSS ON THE TRANSACTION.**

Respondent bases this argument on the well established principle that gain or loss, in a taxable exchange, is measured by the difference between the adjusted cost of the property transferred and the market value of the property received. The validity of the adjusted cost of the property transferred has not been questioned—only the market value of the stock received in the subject transaction is alleged to be undetermined.

The record discloses that petitioner made a written offer (Exhibit 2-B) of clearly described property for shares of stock to be evaluated at Ten Dollars per share (par value). This offer was made to every stockholder.

Under an ancient rule, market value is the price that a willing buyer and a willing seller agree upon when neither of them is under any compulsion to act. Petitioner's stock was not listed on any exchange and

there were no recent transactions (other than those mentioned by Mr. McEnery) from which to obtain pertinent data.

Consequently, petitioner used the only method available to determine whether there were 8,000 shares of stock outstanding that had an agreed value of Ten Dollars per share.

The record also discloses that the property offered by petitioner had a lower market value than its adjusted cost. This fact was known to the stockholders at the time the offer was made. Therefore, from the standpoint of both petitioner and stockholder, all of the elements of the accurate establishment of market value were present.

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#### CONCLUSION

It is respectfully submitted that the Tax Court was in error in the specifications heretofore set forth and judgment should be rendered in favor of petitioner.

Dated, San Mateo, California,  
November 6, 1961.

Respectfully submitted,  
RALPH A. YEO,  
*Attorney for Petitioner.*





No. 17,352

IN THE  
**United States Court of Appeals**  
**For the Ninth Circuit**

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FARMERS UNION CORPORATION,	}
<i>Petitioner,</i>	
VS.	
COMMISSIONER OF INTERNAL REVENUE,	
<i>Respondent.</i>	

---

On Petition for Review of the Decision of the  
Tax Court of the United States

PETITION FOR A REHEARING

---

RALPH A. YEO,  
3404 Fernwood Avenue,  
San Mateo, California,  
*Attorney for Petitioner.*

FILED

APR 5 1962

THOMAS H. BOWMAN, CLERK



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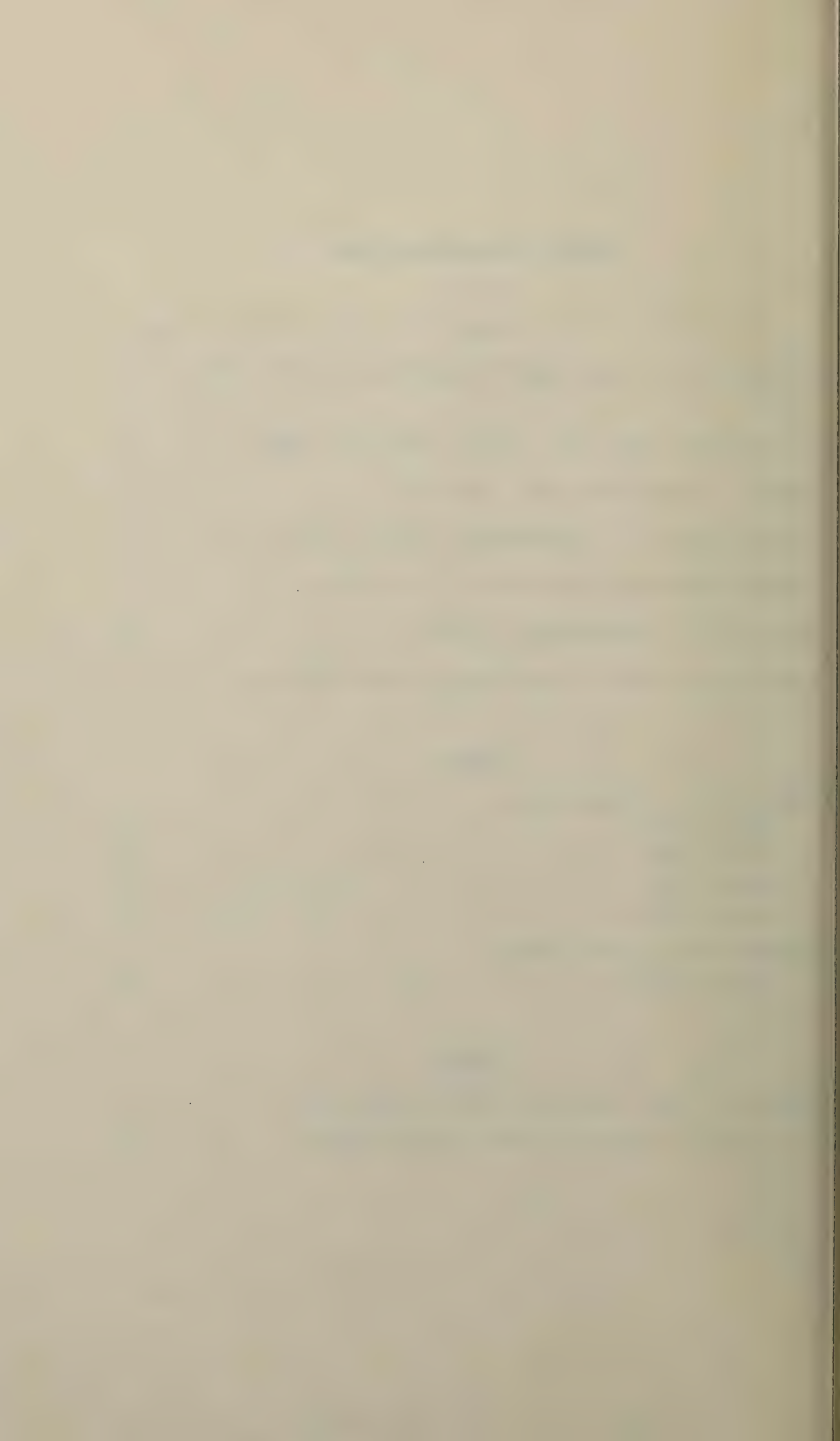
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No. 17,352

IN THE

**United States Court of Appeals  
For the Ninth Circuit**

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FARMERS UNION CORPORATION,	}
<i>Petitioner,</i>	
VS.	
COMMISSIONER OF INTERNAL REVENUE,	
<i>Respondent.</i>	

---

**On Petition for Review of the Decision of the  
Tax Court of the United States**

**PETITION FOR A REHEARING**

---

*To the Honorable Judges of the United States Court  
of Appeals for the Ninth Circuit:*

Petitioner hereby presents its petition for a rehearing and in support thereof respectfully shows:

1. On October 25, 1960, the Tax Court of the United States entered a decision finding income tax deficiencies due by petitioner for the calendar years 1951, 1952 and 1953, holding, in part, that petitioner's exchange of corporation assets for shares of its outstanding capital stock was a partial liquidation and not a sale, as reported by petitioner.

2. On January 19, 1961, petitioner filed a petition for review by this Court.

3. On September 18, 1961, petitioner's opening brief was filed in this Court.

4. Respondent's answering brief was dated October, 1961 and petitioner's reply brief was dated November 6, 1961, both being timely filed with this Court.

5. Petitioner's brief contained arguments, supported by statutes, regulations and judicial precedent, as follows:

A. An exchange of corporation property for shares of its stock is a taxable transaction, in which gain or loss is recognized for income tax purposes, unless the primary purpose of such transaction is to effect a capital readjustment, within the scope of Section 115(i), Internal Revenue Code (1939). Cases cited, in which corporations transferred their property to stockholders in exchange for corporation stock, all emphasized the distinction between taxable transactions with stockholders, involving stock, and calling in, redeeming or purchasing stock for the purpose of revising the capital structure of the corporation. These cases are:

*Commissioner v. Boca Ciega Development Co.*,  
66 F. (2d) 1004;

*Dorsey v. Commissioner*, 76 F. (2d) 339;

*Hammond Iron Co. v. Commissioner*, 122 F.  
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*Trinity Corporation v. Commissioner*, 127 F.  
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*Spear & Co. v. Heiner*, 54 F. (2d) 134;  
*Johnson McReynolds Chevrolet Co.*, 27 T.C.  
300;  
*Country Club Estates, Inc.*, 22 T.C. 1283, 1287,  
1292-3.

B. Reduction of stated capital, as the result of petitioner's acquisition of its own stock in the subject transaction, is an accounting technique and does not affect the capital structure of the corporation,

Sections 1700, 1706, 1710, 1904, *California Corporations Code*.

C. Contraction or termination of business activity of a corporation, resulting from the exchange of assets for stock, is not evidence of liquidation, under the 1939 Internal Revenue Code and Regulations.

6. On December 6, 1961, this case was orally argued before a division of this Court and taken under submission. By written opinion, dated March 8, 1962, this Court affirmed the decision of the Tax Court of the United States. This opinion gave no apparent recognition to the distinction between receiving stock in a commercial transaction and deliberately acquiring it for capital purposes. The opinion also omitted reference to any statutory or judicial authority for the conclusion that reduction of stated capital and contraction of corporate business activity, as consequences of the subject transaction, are indicative or evidence of partial liquidation.

**CONCLUSION**

It is a general rule that there is ground for rehearing if the Court has overlooked material points or decisive authorities duly submitted by counsel.

5 *C.J.S.* 552, "Appeal and Error", Section 1423;

3 *Am. Jur.* 346, "Appeal and Error", Section 398.

A rehearing should be granted upon the above stated grounds to permit more extensive consideration of the law and facts of this case.

Dated, San Mateo, California,  
April 5, 1962.

Respectfully submitted,

RALPH A. YEO,

*Attorney for Petitioner.*

---

**CERTIFICATE OF COUNSEL**

The undersigned, Ralph A. Yeo, is counsel for petitioner. In my judgment, petitioner's petition for rehearing by this Court is well founded. It is not interposed for delay.

Dated, San Mateo, California,  
April 5, 1962.

RALPH A. YEO.







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No. 17354  
IN THE  
**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

---

THE CENTURY INDEMNITY COMPANY, a corporation,  
*Appellant,*  
*vs.*

ROBERT A. RIDDELL, District Director of Internal Revenue for the  
Los Angeles District of California,  
*Appellee.*

---

ROBERT A. RIDDELL, District Director of Internal Revenue for the  
Los Angeles District of California,  
*Appellant,*  
*vs.*

THE CENTURY INDEMNITY COMPANY, a corporation,  
*Appellee.*

---

On Appeal From the Judgment of the United States  
District Court for the Southern District of California.

---

**BRIEF FOR APPELLANT AND  
CROSS-APPELLEE.**

---

**Opinion Below.**

The opinion of the District Court is reported at Par. 9140, 61-1 USTC, and pages 326-328 of the Transcript of Record. References to the opinion herein will be to pages of the Transcript of Record.

**Jurisdiction.**

The Taxpayer's appeal is taken from a portion of a decision and judgment of the United States District for the Southern District of California, Central Division. Its appeal involves Withholding tax on wages of employees of its principal, a subcontractor, under a

surety bond for the period between March 9, 1954, and September 17, 1954 [R. 96], in the amount of \$17,830.66, plus interest.

The Government's appeal involves Federal Insurance Contributions Act taxes, delinquency penalty and interest in the amount of \$10,278.37, plus interest; Federal Unemployment Act taxes and interest in the amount of \$4,113.39, plus interest; Withholding tax on wages, delinquency penalty and interest for the period between December 7, 1953 and March 8, 1954, in the amount of \$8,383.10, plus interest; and the Order Re-Taxing Costs in the amount of \$188.50. [R. 97.]

All the above taxes were assessed against the Taxpayer and paid under protest. [R. 52-55.] The Taxpayer filed three timely claims for refund on January 7, 1958, as follows: Withholding tax for the period from October 1, 1953, to September 30, 1954, in the amount of \$26,213.76; Federal Insurance Contributions Act taxes for the period from October 1, 1953 to September 30, 1954, in the amount of \$10,278.37; and Federal Unemployment Tax for the period from January 1, 1954 to December 31, 1954, in the amount of \$4,113.39. No action was taken with respect to any of the three claims for refund within six months from date of filing. [R. 57.] The Taxpayer thereupon filed a complaint against Robert A. Riddell, District Director of Internal Revenue for the Los Angeles District of California in the District Court for the Southern District of California on October 7, 1958, for refund of said amounts which it alleged had been illegally assessed and collected and thus overpaid. [R. 3-35.] Jurisdiction was conferred on the District Court by 28 U. S. C., Section 1340. Judgment was entered

partially in favor of the Taxpayer and partially in favor of the Government on December 5, 1960. [R. 88-89.] Within 60 days both the Taxpayer and the Government filed notices of appeal, on February 2, 1961, and February 3, 1961, respectively. [R. 96-98.] Jurisdiction is conferred on this Court by 28 U. S. C., Section 1291.

### Question Presented.

On the Taxpayer's Appeal:

The Taxpayer and its principal under a surety bond, a subcontractor, established a joint control bank account. All progress payments under the subcontract were deposited in this bank account. For the period between December 7, 1953, and March 8, 1954, the Taxpayer's representative, as trustee, countersigned one check drawn on this account to cover the subcontractor's payroll for the period covered. This check was then deposited in the subcontractor's Commercial checking account. Individual payroll checks were then issued by the subcontractor to its employees. Some of these checks were drawn on the joint control account and some on the subcontractor's Commercial checking account, but none of these checks was countersigned by a representative of the Taxpayer.

The District Court held that during this period the Taxpayer was not the "employer" of the employees of the subcontractor within the meaning of Sections 1621(d), 1622(a) and 1623 of the 1939 Code and was not liable for Withholding tax of the subcontractor for that period. [R. 87.]

For the period between March 9, 1954, and September 17, 1954, the Taxpayer's representative counter-



signed the individual payroll checks prepared by the subcontractor and which were all drawn on the joint control account with minor exceptions not here material.

The District Court held that for this period the Taxpayer was the “employer” for Withholding tax purposes within the meaning of the applicable Code sections and was liable for the Withholding taxes of the subcontractor for that period. [R. 87.]

Only one question is presented by the Taxpayer’s appeal:

Did the District Court err in holding that the Taxpayer was the “employer” of the employees of the subcontractor for the period between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a), and 1623 of the Internal Revenue Code of 1939, as amended, and thus liable for the Withholding taxes on the wages of such employees?

### **Statutes and Regulations Involved.**

The pertinent provisions of the statutes and Treasury Regulations are printed in the Appendix, *infra*.

### **Statement of the Case.**

The significant facts pertinent to the Taxpayer’s appeal, as stipulated by the parties [R. 46-47], as found by the District Court [R. 81-85], and as set forth in the testimony may be summarized as follows:

On October 6, 1953, White-Ahlgren Company, Inc. (herein sometimes referred to as “Subcontractor”) entered into a subcontract with Marine Development, Inc. (herein sometimes referred to as “Contractor”) for concrete work in connection with the building of a 1,000 unit Wherry Housing Project at Camp Pendleton, Cali-

fornia, for \$549,138.20. This contract provided for monthly progress payments based on the percentage of works performed, less 10% and less all previous payments. Upon acceptable completion of the work and a proper showing by the Subcontractor that all materialmen and laborers had been paid, the 10% retained and any other payments due were payable to the Subcontractor. The contract also required Subcontractor to pay all social security and other taxes imposed on Subcontractor as employer in connection with the labor provided by Subcontractor under the contract and required Payment and Performance Bonds in the full amount of the contract. [Pltf. Ex. 1-B.] As a result of subsequent changes and adjustments, the final amount payable to Subcontractor under the contract was \$551,131.73. [R. 50.]

On October 6, 1953, the same date the subcontract was entered into, Subcontractor executed an Application for Contract Bond and Indemnity Agreement through the Cole Insurance Agency, Inc. of Los Angeles, an authorized agent of the Taxpayer. [Pltf. Ex. 2.] Upon receipt of said application the Taxpayer determined that Subcontractor was under-financed. By letter dated November 16, 1953, addressed to Contractor, the Taxpayer, through D. J. Waite, Attorney-in-Fact, stated, on the subject of adequate financing, that it would issue Subcontractor a bond upon receipt of \$25,000.00 in cash by Subcontractor, which was anticipated to be put in the corporation by November 25, 1953, and an advance payment of \$10,000.00 by Contractor, which specific sum of money was to be deposited in a special bank account of Subcontractor of which the Taxpayer, as surety, would have joint control. [Deft. Ex. A; R. 74-75.]

A Contract Bond was executed December 2, 1953. [Pltf. Ex. 3.] The application for the bond contained a provision in section Fourth that the Taxpayer, as surety, should be subrogated to all rights of Subcontractor in the contract and an assignment of all deferred payments and retained percentages arising out of the contract. The bond provided that if the Subcontractor defaulted in the performance of the contract, the Taxpayer, as surety, had the right, at its option to proceed or procure others to proceed with the performance of the contract.

On December 2, 1953, Subcontractor opened a commercial checking account in the Security Trust and Savings Bank of San Diego, California, known as "White-Ahlgren Trust Account No. 1," over which Subcontractor and the Taxpayer, as surety on the bond, would have joint control. The resolutions and signature cards filed with the bank required all checks drawn against this account to be signed by an authorized signatory of Subcontractor and to be countersigned by any one of several designated representatives of the Taxpayer, who was to sign as trustee. [R. 83.]

Except for retention payments withheld by Contractor pursuant to the contract in the sum of \$54,-249.18 and paid directly by Contractor to the Taxpayer on December 17, 1954, all progress payments made by Contractor under the subcontract were required to be and were deposited in this Trust Account No. 1. [R. 83.]

Subcontractor also had a general commercial account at the same bank with which the Taxpayer had no connection. [Pltf. Ex. 5.] During the months of December, 1953, and January and February, 1954, this



account was used for the payroll for a contract Subcontractor had with Webb & Knapp. The account was closed in August, 1954. [R. 312-313.]

On the same day that Trust Account No. 1 was opened \$25,000.00 was deposited in this account of which \$10,000.00 was advanced by Contractor and \$15,000.00 was a loan to Subcontractor by Hertha A. Clausen. She had agreed to loan Subcontractor \$15,000.00 provided this money and an additional \$10,000.00 would be put under joint control. [R. 105.] This amount was \$10,000.00 less than the required minimum as set forth in Mr. Waite's letter [Deft. Ex. A] but was all deposited in the joint control account whereas he had stated that only the \$10,000.00 advanced by Contractor had to be under joint control. [R. 184-188.] As of December 1, 1953, the balance in Subcontractor's general commercial account was \$9,992.92. [Deft. Ex. E.]

This Trust Account No. 1 continued in existence until December 6, 1954, and was at all times a joint control account.

Work under the subcontract began about December 7, 1953 [R. 83] and was completed by Subcontractor on September 17, 1954. [R. 84.] However, in March, 1954, Subcontractor had fallen behind in the specified rate of performance. Contractor called a meeting at Camp Pendleton at which Eva L. Cole was present as a representative of the Taxpayer. [R. 119-120.] As a result of this conference, Contractor's attorney wrote Mrs. Cole a letter dated March 23, 1954, wherein Contractor agreed to modify the contract to the extent of changing the scheduled rate of performance and of making progress payments on a weekly rather than a month-

ly basis. This letter also stated that the Taxpayer, within 24 hours after receipt of written request from Contractor should take over the subcontract. Except as so modified the subcontract and bond were to remain in full force and effect. [Pltf. Ex. 10.] Upon receipt of this letter by Mrs. Cole, it was turned over to Mr. Burton A. Van Tassel, local counsel for the Taxpayer. He shortly thereafter superseded Mrs. Cole as the representative of the Taxpayer in connection with the subcontract. [R. 120-121.] The letter from Mr. Oakes, the attorney, provided for its approval and agreement by the Taxpayer. However, it was never so approved as the new arrangement was working out, there was no emergency, and approval by the Taxpayer was not insisted upon. [R. 235-238; 259-261.] The Subcontractor continued to perform under the contract, as modified, until its completion. [R. 203-210.]

About the middle of February, 1954, Subcontractor determined that it had underbid on the subcontract. The plans and specifications on which estimates were based showed that garages and driveways were to be of asphalt construction, but the set of plans given to Contractor showed them to be concrete. Subcontractor thus had to pour 2,100 yards of concrete, plus the labor, plus the extra materials that went with it. [R. 224-225.]

Subcontractor became unable to pay all materialmen and incidental labor in connection with the subcontract. The Taxpayer paid said creditors the total sum

of \$119,188.17 [Pltf. Ex. 20] and made recoveries in connection with claims asserted under the terms of the bond in the amount of \$70,723.84. [Pltf. Ex. 1-A.]

The Taxpayer never paid or advanced any of its own funds to meet the payroll of the Subcontractor except for \$1,090.00 deposited in Trust Account No. 1 in September, 1954, to enable Subcontractor to meet in full its final payroll upon completion of the subcontract. [R. 51.]

*Payrolls:* The Subcontractor's payrolls were prepared and checks were issued for its employees in substantially the following manner:

Beginning with the subcontract, Mrs. Higgins, bookkeeper for the Subcontractor, prepared weekly payroll sheets. The foreman delivered the time cards and from them Mrs. Higgins computed the hours, rate of pay, applicable deductions, and the net figure. She then transferred this information to a recap sheet. [R. 303-4; Deft. Ex. X.] A check in the gross amount of each weekly payroll payable to Subcontractor and drawn on Trust Account No. 1 was duly signed by an authorized signatory of Subcontractor and countersigned by a duly authorized representative of the Taxpayer for the period between December 7, 1953, and January 11, 1954, and a similar check in the net amount of the payroll (gross amount less deductions) was issued for the period between January 12, 1954, and March 8, 1954. [R. 84; 109-110.] This check was deposited in Subcontractor's regular commercial ac-



count. Individual payroll checks were then made out by Subcontractor and delivered to its employees. However, instead of the individual payroll checks being drawn on Subcontractor's general account as intended, Subcontractor at first drew a number of individual checks on Trust Account No. 1, which were honored by the Bank although not countersigned by Taxpayer's representative as required [R. 199-201.] A total of 148 checks in the amount of \$9,630.18 were so written and paid before this was discovered. The dates of these checks were from December 18, 1953, through January 8, 1954. [Pltf. Ex. 36.] By letter to the bank dated January 15, 1954, the Taxpayer's representative confirmed a prior telephone conversation and ratified the payment of these checks without the required countersignature. [Pltf. Ex. 25; R. 113-115.] Thereafter for each weekly payroll between January 12, 1954, and March 8, 1954, the same arrangement was continued except that the single payroll check written on Trust Account No. 1 and deposited in Subcontractor's general account was for the net rather than the gross amount of the payroll.

For the period above referred to the District Court held that the Taxpayer was not the "employer" for Withholding tax purposes and was not liable for the Withholding tax of the Subcontractor's employees.

Commencing on March 9, 1954, and ending with the completion of the subcontract on September 17, 1954, wage payments were made weekly to the employees of

Subcontractor directly from Trust Account No. 1. These payments were made by individual checks drawn against Trust Account No. 1 payable to the order of each individual employee in the net amount due. Each check was signed by an authorized signatory of Subcontractor and was countersigned by a duly authorized representative of the Taxpayer, who countersigned as trustee. [R. 84-85.]

During this period the procedure was for the Subcontractor's bookkeeper to prepare a recap sheet and individual payroll checks. The Taxpayer's representative went to Subcontractor's office each week, compared the individual checks with the recap sheet, then countersigned them as trustee. [R. 239-240; 306.]

The only job being performed by Subcontractor during this time was the subcontract here in question, and Subcontractor received no funds from any other contract. [R. 85.]

For the period above referred to the District Court held that the Taxpayer was the "employer" for Withholding tax purposes and was liable for the Withholding tax of the Subcontractor's employees.

### **Specifications of Error.**

The specifications of error relied upon by the Taxpayer are as follows:

1. That the District Court erred in its finding that Taxpayer had control of the payment of the wages of the employees of White-Ahlgren Company, Inc., for

the services rendered by said employees between March 9, 1954, and September 17, 1954. [R. 85];

2. That the District Court erred in its finding that Taxpayer was the “employer” of the employees of White-Ahlgren Company, Inc., between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the 1939 Internal Revenue Code, as amended [R. 87]; and

3. That the District Court erred in its Judgment that Taxpayer take nothing with respect to Withholding taxes and interest paid by Taxpayer to Defendant for the period between March 9, 1954, and September 17, 1954. [R. 88.]

### **Summary of Argument on the Taxpayer’s Appeal.**

1. The individuals performing services in connection with the subcontract were performing them for the Subcontractor and not for the Taxpayer.

2. The subcontractor and not the Taxpayer had control of the payment of the wages for such services within the meaning of Section 1621(d)(1) of the Internal Revenue Code of 1939, as amended. For the Taxpayer to have had control of the payment of the wages within the meaning of the statute, and as held in this Circuit, the Taxpayer would have had to have exclusive rather than merely joint control of such payments. A control “which is equal to the veto power” is not the control required under Section 1621(d) to make a person the employer as held by the District Court.



## ARGUMENT.

### I.

**The Individuals Performing Services in Connection With the Subcontract Were Performing Them for the Subcontractor and Not for the Taxpayer.**

It is abundantly clear from the record, and the District Court found, that the Subcontractor completed the subcontract in question and that all services of employees in connection with the subcontract were performed by them for and on behalf of the Subcontractor. Therefore, without belaboring this point, suffice it to say that the Taxpayer was not the employer within that portion of the statutory definition which states:

“The term ‘employer’ means the person for whom an individual performs or performed any services, of whatever nature as the employee of such person, \* \* \*”

II.

The Subcontractor and Not the Taxpayer Had Control of the Payment of the Wages for Such Services Within the Meaning of Section 1621(d)(1) of the Internal Revenue Code of 1939, as Amended. For the Taxpayer to Have Had Control of the Payment of Wages Within the Meaning of the Statute, and as Held in This Circuit, the Taxpayer Would Have Had to Have Exclusive Rather Than Merely Joint Control of Such Payments. A Control "Which Is Equal to the Veto Power" Is Not the Control Required Under Section 1621(d) to Make a Person the Employer as Held by the District Court.

Before analyzing the law on this point, a prefatory comment would appear pertinent. The Treasury Department is understandably concerned with collecting taxes properly owed. The tax withheld from the income of employees is, of course, in this category. The person who is the "employer" of such employees has the legal obligation to pay such withheld taxes. Cases such as the present case present a difficult problem. Although relatively few in number in relation to the huge volume of such contracts, they have arisen with sufficient frequency to spotlight the difficult problems involved. They do not arise unless something has gone wrong. In short, there is not enough money to go around. Who is going to stand the loss? Here, for example, the Government admittedly did not receive the tax money due it. The Taxpayer, as surety, also lost substantial sums. In such a situation, and as the Government will urge on its appeal, there is an inevitable tendency to urge that the equities are such that

the bonding company, rather than the public revenues, should bear the tax loss. As this cannot be accomplished as a matter of law by holding the surety liable for payroll and withholding taxes under its bond, the argument is made on factual grounds. The position urged is that the surety, or prime contractor as the case may be, has money. The subcontractor does not. Therefore, the latter is in "control" of the payment of the wages under the theory that a "trust fund" is created by statute. This was the position urged upon and adopted by the District Court in *United States v. Swedlow Engineering Co.*, 100 Fed. Supp. 796 (S. D. Cal. 1951). Judge Yankwich reasoned that "without the periodic drafts [of the bonding company] to cover them [the wages] could not have been paid." On appeal this decision was reversed by this Court in a *per curiam* opinion, *sub. nom.*, *Fireman's Fund Indemnity Co. v. United States*, 210 F. 2d 472 (9th Cir. 1954). Nonetheless the rationale behind the lower Court's decision is still, in effect, being urged by the Government.

This is further illustrated by the "Order For Judgment in Favor of Plaintiff" in *Reliance Insurance Company v. United States*, ..... Fed. Supp. .... (N. D. Cal. 1959; Civil Action No. 37234; 60—1 U. S. T. C. Par. 9315). This case is practically on all fours with this Taxpayer's case. In ordering judgment in favor of plaintiff, and the Government took no appeal, Judge Harris stated:

"\* \* \* The legal principles, contained in the statutory definition itself and established by case law, have construed the term 'employer' in a manner which excludes a corporation in plaintiff's posi-



tion from being encompassed within the scope of Section 1621. (a) *Phinney v. Southern Warehouse*, 212 F. 2d, 448; (b) *William Simpson Const. Co. v. Westover*, 100 F. Supp. 125, Aff. 209 F. 2d, 908 (9); (c) *American Fidelity Co. v. Delaney*, 114 F. Supp. 702.<sup>1</sup> Any departure from a strict application of the controlling principles in these decisions, regardless of the equities, results in quick reversal (*Fireman's Fund v. United States*, 100 F. Supp. 796)."

The Judge then went on to say:

"However unconscionable plaintiff's conduct may be in avoiding a just obligation due the government for withholding and social security taxes owed employees of Coast Pipeline, nevertheless defendant cannot prevail under the evidence before the court. Instead, the government must look to relief—at least in the future—through legislative remedies which have long since been enacted by California state authorities to protect tax obligations of a like character."

Despite the obviously strong feelings of the Judge he was impelled, on the basis of the law, to decide the case in favor of plaintiff, the bonding company, and to hold that it was not the employer. This will be discussed later. The case is referred to here to illustrate a point

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<sup>1</sup>(a) Bonding company paying employees of contractor held not 'employer'

(b) Contractor held entitled to recover taxes collected on wages paid subcontractor's employees.

(c) Bonding company, though assisting financially in completion of project, held not to be 'employer' for tax liability."

[A certified copy of the opinion is reproduced in full in the appendix.]

that counsel frankly is unable to grasp. Just why is it “unconscionable” for a person to ask that his tax liability be determined in accordance with the law? Why is he “avoiding a just obligation due the government” when Congress and this Court have stated that he does not have such an obligation?

Congress did in fact give extensive consideration to the problem of securing greater compliance with the law on the part of employers and others in paying over to the Government trust fund moneys withheld from employees, or collected from customers. It enacted P. L. 85-321, effective February 12, 1958. Section 1 added Section 7512 and Section 2 added Section 7215 to the Internal Revenue Code. The remedy adopted by Congress was to provide that where a person fails to collect and pay over the taxes the Internal Revenue Service can require him to deposit such taxes in a special trust account not later than the end of the second banking day after any amount of such taxes is collected and to provide criminal penalties for failure to do so. In the Senate Report explaining these provisions the following paragraph appears:

“Present law in section 6672 provides a civil penalty of 100 percent for any person who willfully fails to collect or truthfully account for and pay over an internal-revenue tax for which he is responsible. However, this civil penalty is ineffective where the employer has lost the employees’ funds in a business venture or where he did not have them in the first place. The latter, which presents one of the most difficult enforcement problems, can be illustrated by a secondary contractor who is without funds, but obtains from the prime

contractor just enough to meet his net payroll. The prime contractor in this case, since he is responsible for the completion of the job, is willing to provide the net wage payments, but since he is not the 'employer' cannot be required to provide the taxes to be withheld by the 'employer.' The secondary contractor who is the 'employer,' apart from the net wage payments, does not have any funds in these cases to set aside as withheld taxes." [S. Rep. No. 1182, 85th Cong. 2d Sess. (1958), 1958—Cum. Bull. 641.]

It is thus clear that Congress was fully cognizant of the problem presented by the situation giving rise to the case now before this Court. Whatever the reason, Congress did not choose to make a surety or a prime contractor the employer liable for payroll and withholding taxes in this type situation. It adopted other remedies and left the then and now existing law with respect to the definition of an employer unchanged.

What is the law?

It is respectfully submitted that the law is quite clear. For the Taxpayer in this case to have had "control" over the payment of the wages of Subcontractor's employees within the meaning of Section 1621(d)(1) and to render this exception to the general definition of "employer" applicable, two things must be shown: (1) that the Subcontractor had no control over the payment of the wages, and (2) that the Taxpayer had. *Westover v. William Simpson Const. Co.*, 209 F. 2d 908 (9th Cir., 1954). Obviously this was not the case. A joint control or "veto power" is not sufficient.

Here the Taxpayer was not advancing its own money to the Subcontractor except for \$1,090.00 advanced for



the final payroll. What it did was to countersign checks so as to be certain that the Contractor's progress payments were properly expended in connection with the subcontract for which the progress payments were made and that the money was not improperly expended or otherwise dissipated for unrelated purposes.

In the opinion of the District Court, Judge Hall stated that for the period to March 18 [when one countersigned check was written to cover the payroll] the taxes came clearly within the *Simpson* case and the *Fireman's Fund* case. However, for the subsequent period when individual payroll checks were countersigned by the Taxpayer's representative, the Taxpayer had a veto power and thus "control."

Counsel have endeavored in vain to find any legal distinction based on this factual difference. What is the difference from the standpoint of the requisite statutory "control" between countersigning one check for the net amount of the payroll and countersigning individual payroll checks in the same net amount? It is respectfully submitted that there is none.

In the *Fireman's Fund* case in Paragraph VII of the Stipulation of Facts the procedure used was stipulated as follows:

"\* \* \* Swedlow Engineering Co., Inc., would prepare a payroll summary, \* \* \* and write a check for the net or 'take home' pay of each of its employees for the week immediately preceding. Each check bore a number, stated the amount for which it was payable and the name of the payee. The numbers of the checks issued to meet the payroll items were set forth in the left hand margin of the payroll summary. The payroll summary with

a list and description of the checks drawn to cover its items was then forwarded to the defendant, Fireman's Fund Indemnity Company, with the request that it meet said payroll by authorizing the payment of said checks. Upon receipt of said payroll summary and list of checks with the accompanying request that they be made good, Fireman's Fund Indemnity Company drew its draft [14] payable to Broadway State Bank, for an amount exactly sufficient to cover the payroll checks and other checks drawn by Swedlow Engineering Co., Inc., and transmitted said draft together with the list of the checks to be paid from the proceeds of said draft to Swedlow Engineering Co., Inc.'s bank, the Broadway State Bank, 8564 South Broadway, Los Angeles, California, with instructions that the proceeds of said draft be used by said bank to make good the described checks and nothing else."

Under this arrangement the bonding company patently had just as much control over the payment of the individual payroll checks written by the contractor and which were covered by the bonding company's draft as would have been the case had the bonding company written individual checks of its own to cover the payroll.

Assuming, *arguendo*, that the mechanics of countersigning one check for the total net payroll rather than countersigning the individual payroll checks constitutes a substantial factual difference, it is clear that this difference is without legal significance. This is illustrated not only in this Circuit by *Westover v. William Simpson Const. Co.*, *supra*, but in other Circuits by such

cases as *Phinney v. Southern Warehouse Corporation*, 212 F. 2d 488 (5th Cir. 1954). In that case the taxpayer was the owner for whom the work was being performed. The contract called for progress payments less a 15% retention to be held by the owner as security for completion of the contract. The contractor got into financial trouble and prevailed on the owner to advance a portion of the retentions to permit the job to be completed. The owner, with the consent of the surety, deposited funds in a special checking account to be used to pay bills and wages incurred on the job. Withdrawals were authorized under the signature of an employee of the contractor and an agent of the owner. The Circuit Court affirmed the decision of the District Court that the owner did not become the employer of the employees of the contractor under this arrangement, citing *Westover v. William Simpson Construction Co.*, *supra*. In this case the argument of the Government was that the arrangement “took away from Gaddy, [the contractor] power as an independent contractor to dispose of the funds advanced according to his own judgment \* \* \*.” In other words, the Government contended the owner had a “veto power.” The Courts found no merit in this argument.

In *Reliance Insurance Co. v. United States*, *supra*, Coast Pipeline Contractors became unable to meet its payrolls. It went to its surety for financial assistance. [Tr. 216-218.] The surety covered the outstanding payroll checks by drafts and then made arrangements to lend additional funds to the contractor. [Tr. 72-74.] Commencing in June, 1954, the surety loaned money to cover part of the payrolls of the contractor by depositing funds in the bank account of the contractor. Checks



were drawn on this account over the signature of the contractor's office manager and the countersignature of the surety's representative. [Tr. 75-76.] On these facts, and despite the apparently strong feelings of Judge Harris as to what the law should be, as noted above, he held that the surety did not have control over the payment of the wages and did not become the employer of the contractor's employees within the meaning of the statute.

If this is the law where the plaintiff taxpayer suing for a refund has in fact advanced the money, *a fortiori*, it should be, and it is submitted is, the law where the taxpayer has not advanced the money.

The Withholding tax provisions were enacted as part of the Current Tax Payment Act of 1943. The conference report makes it clear that the exception to the general definition of "employer" contained in Section 1621(d)(1) was primarily intended to cover certain special cases where the wage payments are not under the control of the person for whom the services were performed, as, for instance, in the case of certain types of pension payments. In the House bill it was provided that if the wages were paid by a person other than the person for whom the services were performed, the term "employer" meant the person paying such wages. The Senate bill restated the exception in order to make clear that it was designed solely to meet unusual situations and not intended as a departure from the basic purpose to centralize responsibility for withholding, returning, and paying the tax and furnishing receipts. The pertinent portion of this report is set forth in the appendix. It is referred to here as a clear indication that the "control" referred to in the statute as defining the term

“employer” means primarily the *person paying* the wages. In this case, the Taxpayer was not the person paying the wages. Further, it did not have the “control” over such payments required by the statute. Finally, although the Taxpayer vigorously denies that the Subcontractor was the “captive of plaintiff”, who at all times controlled the Subcontractor’s ability to pay taxes, wages and materialmen, as contended by the Government, this would not make the Taxpayer the “employer,” assuming it were true. This is the same argument advanced by the Government in the *Fireman’s Fund* and *Southern Warehouse* cases. This argument has uniformly been rejected by this Court and other Courts.

### Conclusion.

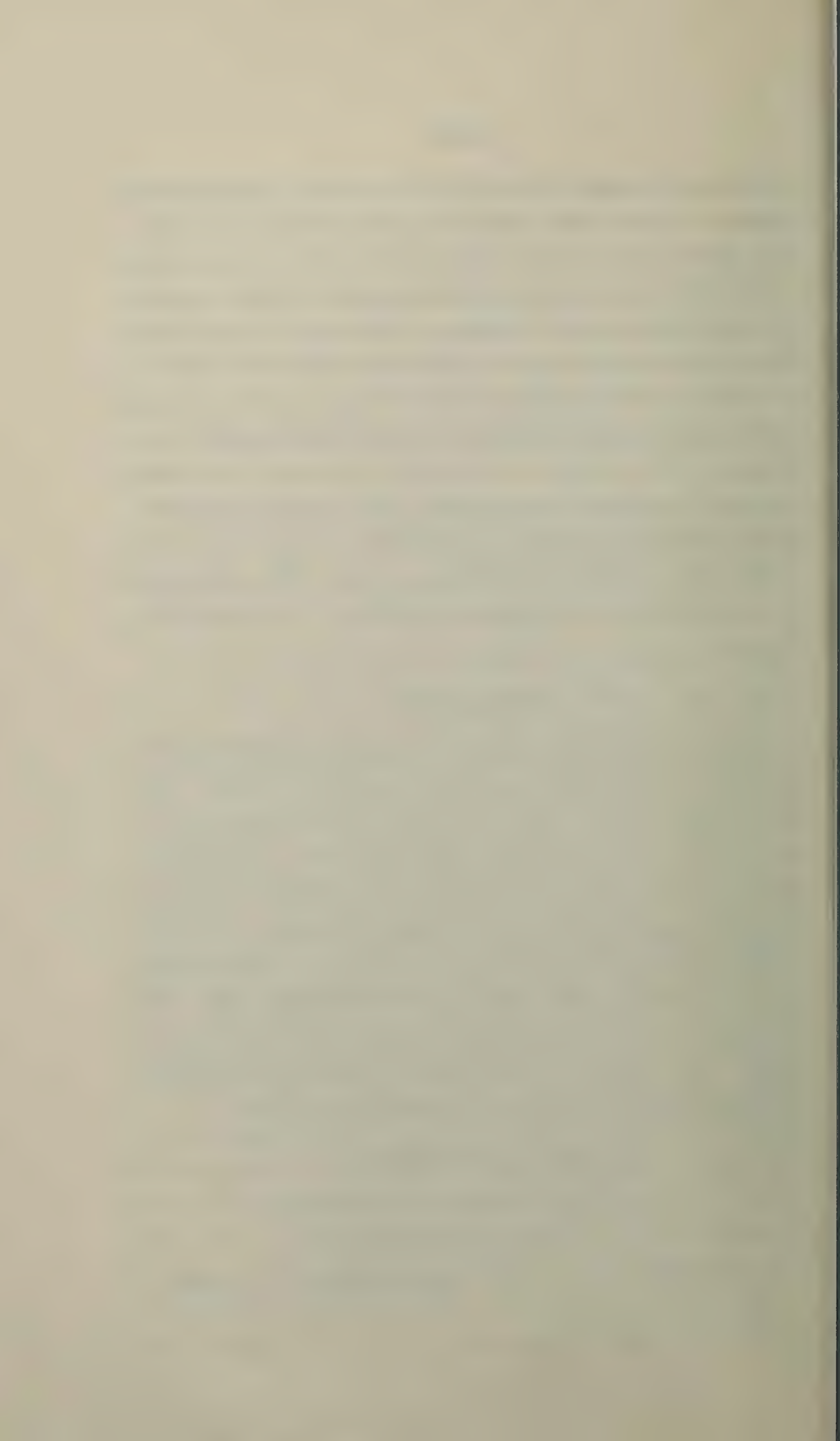
On the Taxpayer’s appeal it is submitted that the District Court’s decision was in error in holding that the Taxpayer was the “employer” of the employees of the Subcontractor between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the Internal Revenue Code of 1939, as amended, and that the Taxpayer was entitled to take nothing with respect to Withholding taxes and interest paid by the Taxpayer to defendant for this period. This portion of the decision should be reversed. The remainder of the decision should be affirmed.

Respectfully submitted,

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*Attorneys for Taxpayer.*









## APPENDIX.

### Statutes Involved.

#### Subchapter D—Collection of Income Tax at Source of Wages.

Sec. 1621, Internal Revenue Code of 1939, as amended, 26 U. S. C. 532—DEFINITIONS.

As used in this subchapter—

(a) *Wages*.—The term “wages” means all remuneration (other than fees paid to a public official) for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash; except that such term shall not include remuneration paid— \* \* \*

(b) *Payroll Period*.—The term “payroll period” means a period for which a payment of wages is ordinarily made to the employee by his employer, and the term “miscellaneous payroll period” means a payroll period other than a daily, weekly, biweekly, semimonthly, monthly, quarterly, semiannual, or annual payroll period.

\* \* \*

(d) *Employer*. The term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” (except for the purposes of subsection (d)) means the person having control of the payment of such wages;

\* \* \*



Sec. 1622, Internal Revenue Code of 1939, as amended, 28 U. S. C. 535. Income Tax Collected at Source.

(a) *Requirement of Withholding.*—Every employer making payment of wages shall deduct and withhold upon such wages a tax equal to: [Formula omitted.]

\* \* \*

Sec. 1623, Internal Revenue Code of 1939, as amended, 26 U. S. C. 558. Liability for Tax.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this subchapter, and shall not be liable to any person for the amount of any such payment.

### *Regulations*

U. S. Treas. Reg. 120, Sec. 406.205 (December 22, 1953).

#### EMPLOYER.—

(a) The term “employer” means any person for who an individual performs or performed any service, of whatever nature, as the employee of such person.

(b) It is not necessary that the services be continuing at the time the wages are paid in order that the status of employer exist. Thus, for purposes of withholding, a person for whom an individual has performed past services for which he is still receiving wages from such person is an “employer.”

(c) If the person for whom the services are or were performed does not have legal control of the payment of the wages for such services, the term “employer” means (except for the purpose of the definition of “wages”) the person having such control. For example, where

wages, such as certain types of pensions or retired pay, are paid by a trust and the person for whom the services were performed has no legal control over the payment of such wages, the trust is the “employer.”

(d) The term “employer” also means (except for the purpose of the definition of “wages”) any person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States (including Puerto Rico as if a part of the United States).

(e) It is a basic purpose to centralize in the employer the responsibility for withholding, returning, and paying the tax and furnishing the statement required under Section 1633. The foregoing two special definitions of the term “employer” are designed solely to meet unusual situations. They are not intended as a departure from the basic purpose.

(f) An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group, or entity. A trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer.

(g) The term “employer” embraces not only individuals and organizations engaged in trade or business, but organizations exempt from income tax, such as religious and charitable organizations, educational institutions, clubs, social organizations and societies, as well as the governments of the United States, the States, Territories, Puerto Rico, and the District of Columbia, including their agencies, instrumentalities, and political subdivisions.

*Committee Reports*

Extract from H.R. 510, 78th Cong., 1st Sess. (Conf. Rept.) 1943 Cum. Bull. 1351, 1353:

“Section 465(c) and (e) of the Code contains definitions of the terms ‘withholding agent’ and ‘employer,’ respectively. Under the House bill and under the bill as passed by the Senate, the definition of withholding agent has been eliminated. Both bills generally define the term ‘employer’ to mean the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. This general definition is not adequate, however, to cover certain special cases, such as the case where the local agent of a nonresident alien individual, foreign partnership, or foreign corporation pays wages to a citizen or resident of the United States, and the case of the person making payment of wages in situations where the wage payments are not under the control of the person for whom the services are or were performed, as, for instance, in the case of certain types of pension payments. The House bill provided for these cases by an exception to the general definition of the term ‘employer’ which provided that if the wages are paid by a person other than the person for whom the services are or were performed, the term ‘employer’ means the person paying such wages. The Senate bill has restated the exception in order to make clear that it is designed solely to meet unusual situations and not intended as a departure from the basic purpose to centralize responsibility for with-



holding, returning, and paying the tax and furnishing receipts.

Accordingly, the Senate bill provides in Section 1621 (d)(1) that if the person for whom the services are or were performed does not have control of the payment of the wages for such services the term 'employer' means the person having control of the payment of such wages. Section 1621(d)(2) provides that in the case of a person who pays wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, which is not engaged in trade or business within the United States the term 'employer' means the person who pays the wages.

"As stated, Section 1621(d) makes it clear that the responsibility for withholding, paying, and returning the tax and furnishing receipts rests with the employer, except as otherwise specifically provided in section 1624. In the case of a corporate employer having branch offices, the branch manager or other representative may actually, as a matter of internal administration, withhold the tax or prepare the receipts required under section 1625, but the responsibility and legal duty for withholding, paying, and returning the tax and furnishing the receipts rests with the corporate employer."

### Order for Judgment in Favor of Plaintiff.

In the District Court of the United States for the Northern District of California, Southern Division.

Reliance Insurance Company, a corporation, Plaintiff,  
v. United States of America, Defendant. No. 37234.

Plaintiff seeks to recover a refund of substantial employment taxes distrained by defendant upon plaintiff's bank account following a summary assessment against plaintiff in 1956. Defendant prepared the assessment, based upon plaintiff's alleged liability for withholding and social security taxes as an "employer" for the third quarter of 1954. During this period plaintiff, bonding company for Coast Pipeline, controlled the financial affairs of the latter corporation because of its probable insolvency and its monetary difficulties.

The legal question confronting the court arises out of the diverse interpretation by the parties of the term "employer" as set forth in 26 U.S.C.A. 1621, the section under which defendant acted in fixing plaintiff's liability for the disputed taxes. The legal principles, contained in the statutory definition itself and established by case law, have construed the term "employer" in a manner which excludes a corporation in plaintiff's position from being encompassed within the scope of Section 1621. (a) *Phinney v. Southern Warehouse*, 212 F.2d 488; (b) *William Simpson Const. Co. v. Westover*, 100 F. Supp. 125, aff. 209 F.2d 908(9); (c) *American Fidelity*

Co. v. Delaney, 114 F. Supp. 702.<sup>1</sup> Any departure from a strict application of the controlling principles in these decisions, regardless of the equities, results in quick reversal (*Fireman's Fund v. United States*, 100 F. Supp. 796).

The pattern of plaintiff's conduct, through its representatives who took over the helm of Coast Pipeline during the period of financial crisis in 1954, was such as to place it within the legal protection afforded and delineated by the adjudicated citations, *supra*. In fact, the evidence points to behavior by plaintiff both planned and ingeniously carried out to avoid tax liability.

However unconscionable plaintiff's conduct may be in avoiding a just obligation due the government for withholding and social security taxes owed employees Coast Pipeline, nevertheless defendant cannot prevail under the evidence before the court. Instead, the government must look to relief—at least in the future—through legislative remedies which have long since been enacted by California state authorities to protect tax obligations of a like character.

Accordingly, It Is Ordered that judgment be entered in favor of plaintiff for a refund in the amount of

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<sup>1</sup>(a) Bonding company paying employees of contractor held not "employer"

(b) Contractor held entitled to recover taxes collected on wages paid subcontractor's employees

(c) Bonding company, though assisting financially in completion of project, held not to be "employer" for tax liability



\$23,642.05, together with interest from the date of payment. Plaintiff shall prepare findings of fact, conclusions of law and judgment consistent with this order.

Dated: November 27, 1959.

GEORGE B. HARRIS,  
United States District Judge

Original filed Nov. 20, 1959. Clerk, U. S. Dist. Court, San Francisco.

I hereby certify that the annexed instrument is a true and correct copy of the original on file in my office.

Attest:

JAMES P. WELSH  
Clerk, U. S. District Court  
Northern District of California

By /s/ JOSEPH A. BAVARESCO  
JOSEPH A. BAVARESCO  
Deputy Clerk

[Seal]

Dated Nov. 28, 1961.

No. 17354

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

CENTURY INDEMNITY COMPANY,

*Appellant,*

*vs.*

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

*Appellee,*

and

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

*Appellant,*

*vs.*

CENTURY INDEMNITY COMPANY,

*Appellee.*

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On Appeals From the United States District Court for the  
Southern District of California.

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## BRIEF AND APPENDICES FOR THE DIRECTOR.

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FILED

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No. 17354

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

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CENTURY INDEMNITY COMPANY,

*Appellant,*

*vs.*

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

*Appellee,*

and

ROBERT A. RIDDELL, District Director of Internal Revenue for the Los Angeles District of California,

*Appellant,*

*vs.*

CENTURY INDEMNITY COMPANY,

*Appellee.*

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On Appeals From the United States District Court for the Southern District of California.

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BRIEF AND APPENDICES FOR THE  
DIRECTOR.

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Opinion Below.

The opinion of the District Court (R. 327-328) is not officially reported.



### Jurisdiction.

This action involves the liability of the taxpayer, Century Indemnity Company, for withholding taxes for the period between December 7, 1953, and September 17, 1954. On August 22, 1956, Robert A. Riddell, the District Director of Internal Revenue for the Los Angeles District of California (hereinafter referred to as the District Director), made assessments against taxpayer of *inter alia*, withholding taxes for the fourth quarter of 1953 and the first three quarters of 1954. On November 12, 1957, taxpayer, under protest, paid the assessed taxes and interest to the District Director. On January 7, 1958, the taxpayer filed a timely claim for refund of the amount assessed and paid, namely, \$26,213.76. (R. 52-54.) No action having been taken on the claim for refund within six months, taxpayer filed a complaint, within the time provided in Section 3772 of the Internal Revenue Code of 1939, against the District Director in the United States District Court for the Southern District of California, Central Division, on October 7, 1958, praying for refund. (R. 3-35.) The answer of the District Director denying that the assessment and collection of the taxes from taxpayer was in any manner illegal was filed on December 8, 1958. (R. 35-44.) Jurisdiction was conferred on the District Court by 28 U.S.C., Section 1340. The findings of fact and conclusions of law were filed on December 5, 1960, and the judgment of the District Court was entered December 6, 1960. (R. 80-89.)

The judgment was in part for the Director and in part for the taxpayer. Notice of Appeal was filed by the taxpayer on February 2, 1961, and notice of cross-appeal was filed by the District Director on February 3, 1961. (R. 95-97.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

### Questions Presented.

The District Court held taxpayer was not liable to the District Director for payment of the federal income withholding taxes here involved relating to the period from December 7, 1953, to March 7, 1954, but held taxpayer was liable for payment of these taxes insofar as they related to the period from March 8, 1954, to September 17, 1954. The District Court determined that taxpayer had “control of the payment of the wages” and thus was liable during the latter period because for that time it authorized payment of wages from the trust account only by individual checks directly to the employees. Taxpayer was awarded judgment for refund of the withholding taxes which it had paid only with respect to the former period.<sup>1</sup>

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<sup>1</sup>The taxpayer was also awarded judgment for refund of the FICA and FUTA taxes which it had paid to the District Director and which it sought to recover in the court below. The District Court held that taxpayer was not the “employer” within the meaning of the statute for the purposes of these taxes. The holding of the District Court is not contested on appeal. The District Director’s appeal with respect to the taxing of costs in the District Court is withdrawn.

The sole question presented by the taxpayer's appeal is whether the District Court erred in holding that taxpayer, during the period from March 8, 1954, to September 17, 1954, had "control of the payment of the wages" to individuals employed in connection with the performance of a subcontract let to White-Ahlgren Company, Inc., within the meaning of Section 1621(d) of the 1939 Code so as to be their "employer" within the terms of the statute and liable for withholding taxes on the wages paid to them during that time.

The sole question presented by the District Director's cross-appeal is whether the District Court erred in holding that taxpayer, during the period from December 7, 1953, to March 7, 1954, did not have "control of the payment of the wages" to individuals employed in connection with the performance of a subcontract let to White-Ahlgren Company, Inc., within the meaning of Section 1621(d) of the 1939 Code so as not to be their "employer" within the terms of the statute and thus not liable for withholding taxes on the wages paid to them during that time.

### Statute and Regulations Involved.

The pertinent provisions of the Internal Revenue Code and the applicable Treasury Regulations are set forth in the Appendix, *infra*.



### Statement.

The pertinent facts, as stipulated (R. 46-57) and as found by the District Court (R. 81-85), may be set forth as follows:

The taxpayer at all pertinent times was a Connecticut corporation qualified to do business in the State of California. (R. 81.)

On October 6, 1953, White-Ahlgren Company, Inc. (hereinafter referred to as White-Ahlgren) entered into a subcontract with Marine Development, Inc. (hereinafter Marine) whereby it undertook to complete the concrete work on a 1,000 unit Wherry Housing Project at Camp Pendleton, California. (R. 82.)

At the same time, White-Ahlgren made a written application to taxpayer for a contract bond and agreement of indemnity in the amount of its subcontract with Marine, namely, \$549,138.20. (R. 47.)

Thereafter, on December 2, 1953, a surety bond described as Contract Bond No. 291379 in the amount of \$549,138.20 was executed by and on behalf of White-Ahlgren as principal, the taxpayer as surety, Marine as owner, and Republic National Bank of Dallas, Texas as mortgagee. Under the bond, taxpayer guaranteed to Marine and the mortgagee the faithful performance of the subcontract and the payment of all labor and material incurred in connection with such performance. Work under the subcontract began on December 7, 1953. (R. 47, 82-83.)

At the time the bond was executed, White-Ahlgren opened a commercial checking account in the Security Trust and Savings Bank of San Diego, California which was designated "White-Ahlgren Trust Account No. 1" (hereinafter the trust account) and over which White-Ahlgren and taxpayer, as surety, had joint control. The resolutions and signature cards filed with the bank required all checks drawn against the trust account to be signed by an authorized representative of White-Ahlgren and to be countersigned by any one of several designated representatives of taxpayer. The latter was to sign as trustee. (R. 47-48, 83.)

Except for retention payments in the sum of \$54,-249.18 paid directly by Marine to taxpayer on December 17, 1954, all progress payments made by Marine under the subcontract were required to be and were deposited directly into the trust account. The only job being performed by White-Ahlgren was the subcontract with Marine and at no time did White-Ahlgren receive any funds from any other job, contract or subcontract. (R. 83-85.)

Weekly payrolls for the employees of White-Ahlgren were made up by the latter's bookkeeper in the following manner: A time card for each employee was prepared by the foreman for White-Ahlgren and presented to the bookkeeper for computation. A recap of the total payroll was then prepared by the latter showing each employee's name, hours worked, rate of pay, gross amount due, total tax deductions, and net amount due, and a copy of the payroll recap was furnished to the representative of taxpayer before the net amounts were paid to the individual employees. (R. 49.)

For the period between December 7, 1953, and March 8, 1954, a weekly check payable to White-Ahlgren in the amount of the payroll was drawn on the trust account. The checks were signed by an authorized signatory of White-Ahlgren and countersigned by a duly authorized representative of taxpayer as trustee. For the period between December 7, 1953, and January 11, 1954, the check was drawn in the gross amount of each weekly payroll. Between January 12, 1954, and March 8, 1954, the check was drawn in the net amount of each weekly payroll, *i.e.*, the weekly gross amount of wages less federal withholding, Federal Insurance Contributions Act taxes and state taxes. The checks were deposited in the White-Ahlgren general account and checks to the individual employees were drawn from this account. (R. 84, 314.)

Commencing March 9, 1954, and ending with the completion of the subcontract on September 17, 1954, wage payments were made directly to the employees of White-Ahlgren from the trust account. The payments were made weekly by means of individual checks, drawn against the trust account, which were made payable to the order of each individual employee in the net amount due. Each of the checks was signed by an authorized signatory of White-Ahlgren and countersigned by a duly authorized representative of taxpayer as trustee. (R. 84-85.)

At no time pertinent herein did taxpayer have control over the employees of White-Ahlgren with reference to the hiring and discharge of employees, the work to be performed by the employees, the hours during which the employees were to perform their work, and the rate of pay to be received by the employees for their services. (R. 83-84.)



The District Court found as ultimate facts that the taxpayer did not have control of the payment of wages of the employees of White-Ahlgren for the period between December 7, 1953, and March 8, 1954, but that it did have control of the payment of their wages for the period between March 9, 1954, and September 17, 1954. (R. 84, 85.) Accordingly, the trial court concluded that the taxpayer was not the “employer” of the employees of White-Ahlgren for the period between December 7, 1953, and March 8, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the 1939 Code and that it was not liable for the payment of withholding taxes for that period. The court held, with respect to the period between March 9, 1954, and September 17, 1954, that the taxpayer was the “employer” of the employees of White-Ahlgren within the statute because of its control of the payment of wages and thus was liable for the payment of withholding taxes for that period. (R. 86-87.)

### **Statement of Points to Be Urged by Director on His Cross-Appeal.**

1. The District Court erred in holding that taxpayer, during the period December 7, 1953, to March 8, 1954, did not have “control of the payment of the wages”, within the meaning of Section 1621(d)(1) of the 1939 Internal Revenue Code, to employees engaged in a construction project subcontracted to White-Ahlgren Company, Inc.

2. The District Court erred in holding that the taxpayer was not, during the period December 7, 1953, to March 8, 1954, the “employer”, within the meaning of Section 1621(d)(1) of the 1939 Internal Revenue Code,

of employees engaged in a construction project subcontracted to White-Ahlgren Company, Inc.

3. The District Court erred in failing to hold taxpayer, for the period December 7, 1953, to March 8, 1954, liable for income withholding taxes under Sections 1622 and 1623 of the 1939 Internal Revenue Code on the wages of employees engaged in a construction project subcontracted to White-Ahlgren Company, Inc.

### Summary of Argument.

Provisions of the Internal Revenue Code applicable for the periods here involved require every "employer" making payment of wages to an individual to deduct and withhold from such wages a prescribed portion thereof, as an income withholding tax on wages, and to pay the withheld portion of such wages over to the District Director of Internal Revenue quarterly.

The sole question presented on this appeal is whether the taxpayer, was, from December 7, 1953, to September 17, 1954, the "employer", within the meaning of the statute, of the employees engaged in the construction project subcontracted to White-Ahlgren. More specifically, the question is whether taxpayer had "control of the payment of the wages" to these employees, as specified in Section 1621(d)(1) of the 1939 Code. If it did, then it is the "employer", as defined by the statute, and is, accordingly, liable for the federal income withholding taxes in question. We submit, on the plain facts of this case, that the taxpayer, at all pertinent times, had "control of the payment of the wages." Thus, we agree with the District Court insofar as it held that taxpayer had "control of the payment of the wages" in this case (namely, for the period from March



8, 1954, to September 17, 1954) but we believe the lower court erred in holding that taxpayer did not have “control of the payment of the wages” for the period from December 7, 1953, to March 7, 1954. The facts establish that the statutory control existed throughout all the time involved herein.

As the pertinent Treasury Regulations point out, the statutory language “control of the payment of the wages” means *legal* control of such payments. Thus, the important and controlling factor is whether the taxpayer has, in law, control of the funds or other means by which payment is made. The reason is plain. Clearly, only the person who legally controls the funds for payment of wages to employees is in a position to comply with the requirement of the Internal Revenue Code that specified amounts be withheld and collected from them for the benefit of the United States.

The facts of record show that the taxpayer, as a condition precedent to the issuance of the bond to White-Ahlgren, insisted upon and acquired legal title to and legal control of *all* funds earned under the subcontract between White-Ahlgren and Marine through a trust account arrangement. The taxpayer had absolute legal control of the funds for payment of wages and as a result, was the only person in a position to effect compliance with the requirement of withholding.

The facts of record further establish that the parties involved, including taxpayer’s attorney, believed that the taxpayer was liable for the withholding taxes.

In actual fact, the taxpayer in this case was, through its legal control, using funds belonging to the United States Government to reduce its liability under the bond



on which it was surety for White-Ahlgren. By using these funds to pay materials bills and other pressing debts instead of holding them for the rightful owner, the Government, the taxpayer avoided expenditures otherwise necessary out of its own pocket. This is a far different situation than existed in the cases upon which taxpayer relies in its brief filed in this Court where there was nothing more than a mere supplying of money by a lender in the amount of the net payroll.

The decided cases holding that a trustee in bankruptcy, who makes payments in respect of wages earned by the bankrupt's employees before the bankruptcy is an employer for income withholding tax purposes within the meaning of Section 1621(d)(1) are most nearly in point here. The trustees in those cases, as the trustee representatives of the taxpayer in the instant case, succeeded as trustees to the legal custody and control of the funds out of which payment was made and thus, under the statute, are liable to withhold income taxes on wages paid out of the funds.

It is clear that the taxpayer in the instant case was in "control of the payment of the wages" within the meaning of Section 1621(d)(1) to employees engaged in a construction project subcontracted to White-Ahlgren throughout the entire period here involved—*i.e.*, from December 6, 1953, to September 17, 1954—and is liable for federal income withholding taxes on the wages paid.

## ARGUMENT.

Taxpayer, During the Period From December 7, 1953, to September 17, 1954, Was the "Employer" Within the Terms of the Internal Revenue Code of Individuals Employed in Connection With a Subcontract Let to White-Ahlgren Company, Inc., and Thus Was Liable for Withholding Taxes on Wages Paid to Them During That Time.

### A. Preliminary.

This appeal involves the liability of the taxpayer, the Century Indemnity Company, for federal income withholding taxes, along with a penalty and interest, for the fourth quarter of 1953 and the first three quarters of 1954. These taxes in the amount of \$26,213.76 (including penalty and interest) (R. 54) were assessed against taxpayer in connection with wages paid on construction work performed by White-Ahlgren Company, Inc., under a subcontract let by Marine Development, Inc., for which the taxpayer acted as surety. The taxes were assessed under authority of Sections 1622(a) and 1623 of the 1939 Internal Revenue Code, Appendix A, *infra*.

Section 1622(a) requires every "employer" making payment of wages for the periods here involved to deduct and withhold upon such wages a tax equal to a specified percent of the amount by which the wages exceed the number of withholding exemptions, computed as therein provided. Section 1623 makes the "employer" liable for the payment of the tax required to be withheld under the subchapter dealing with the withholding tax.

The sole question presented on this appeal is whether the taxpayer was, from December 7, 1953, to September

17, 1954, the “employer”, within the meaning of the statute, of the employees engaged in the construction project pursuant to the subcontract let to White-Ahlgren. More specifically, the question is whether taxpayer had “control of the payment of the wages” to these employees. If it did, then it is the “employer” as defined by the statute and it is, accordingly, liable for the aforementioned federal income withholding taxes.

Section 1621(d)(1) of the 1939 Code (Appendix A, *infra*) defines the term “employer” for purposes of the withholding tax, as follows:

The term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” (except for the purposes of subsection (a)) means the person having control of the payment of such wages; \* \* \*

Thus, the “employer”—the one who has the legal responsibility for withholding income taxes—is that person who has “control of the payment of the wages.”

We submit, on the plain facts of this case, that the taxpayer, at all pertinent times, had “control of the payment of the wages” herein and that, accordingly, it is liable for withholding taxes on these wages as required by the Internal Revenue Code. Thus, we agree with the District Court insofar as it held that taxpayer had “control of the payment of the wages” in this case (namely, for the period from March 8, 1954, to



September 17, 1954) but we believe the lower court erred in holding that taxpayer did not have “control of the payment of the wages” for the period from December 7, 1953, to March 7, 1954. The facts establish that the statutory control existed throughout all the time involved herein.

**B. Taxpayer, at All Pertinent Times, Had “Control of the Payment of the Wages.”**

It should be noted at the outset, as the pertinent Treasury Regulations (Treasury Regulations 120 (1939 Code), Section 406.205(c), Appendix A, *infra*) point out, that the statutory language “control of the payment of the wages” means *legal* control of such payments. Thus, the important and controlling factor in applying the statutory exception (Section 1621(d)(1)) is whether the taxpayer has, in law, control of the funds or other means by which payment is made. It is not significant for purposes of this exception who controls and performs the tasks of preparing the payroll sheets or making out the payroll checks.<sup>2</sup> See Rev. Rul. 57-22, 1957-1 Cum. Bull. 318; Rev. Rul. 54-471, 1954-2 Cum. Bull. 348. The important consideration is legal control of the funds for payment. The reason is plain. Clearly, only the person who legally controls the funds for payment of wages to employees is in a position to comply with the requirement of the Internal Revenue Code that specified amounts be withheld and collected from them for the benefit of the United States.

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<sup>2</sup>Nor, of course, is it pertinent in determining “legal” “control of the payment of the wages” who has control with reference to the hiring and discharge of employees, the hours during which the work is to be performed and the rate of pay to be received.

The facts of record in the instant case leave no doubt that it was the taxpayer who controlled the funds by which payment was made to employees working under the subcontract let to White-Ahlgren by Marine and that this control existed throughout the entire time the subcontract was being performed, namely, from December 7, 1953, to September 17, 1954—the period in question here. Only the taxpayer was in a position to comply with the requirement of withholding.

The evidence of record establishes that taxpayer required as a condition precedent to the issuance of the bond to White-Ahlgren (guaranteeing the performance and payment of labor and material bills in the amount of 100% of the contract price) that a trust account be established in its behalf. The trust account was to be the depository for extra financing at the outset and for all monies earned under the subcontract when due. Demont J. Waite, the manager of taxpayer's bonding department in Los Angeles during all pertinent times, testified on cross-examination by the attorney for the District Director regarding this requirement as follows (R. 194-196):

Q. Mr. Waite, to make sure that I understand you clearly, when they originally applied to you for a bond, you felt they were underfinanced and would not write the bond unless the extra cash was put up? A. That is right.

Q. The original requirement with regard to extra cash was for them to put up \$25,000 and Marine Development to advance \$10,000? A. May I answer that other than yes or no?

Q. Let me put it this way: Is that what you indicated in this letter [Defendant's Exhibit A, Appendix B, *infra*]? A. Yes.

Q. Now, as a matter of fact, however, you did eventually authorize the issuance of the bond when only a total of \$25,000 was put up? A. That is right.

Q. Only \$15,000 cash to the company and Marine Development's \$10,000? A. Yes, sir.

The Court: And you began to sign the checks after the \$25,000 had long previously been spent?

The Witness: I presume so.

The Court: So it was your intention here that the trustee account would not be limited primarily to the expenditure of the \$35,000?

The Witness: Oh, no.

The Court: And it was your intention that all money expended by them on that job should go in a joint trust account?

The Witness: Yes, sir.

The Court: A joint account?

The Witness: Yes, sir.

Q. (By Mr. Sherman): Well, then, knowing that they were underfinanced and knowing that they had not even met your original requirements of deposit, didn't you, as the bonding manager for your company insist, as indicated in this letter, that the funds to be expended on the job be subject to the control in part of your company? A. No, sir. May I answer in my own words now to give you the story?

The Court: You can explain your answer if you desire.

The Witness: My original action was to turn the bond down, and when Mrs. Cole as agent came to me with other plans and financing thoughts that were to be included then I went ahead and said,



well, yes, maybe we can work it out on that basis.

Q. (By Mr. Sherman): Regardless of whose idea originally it was—whether Mrs. Cole's or yours—you did adopt this suggestion that you acquire a joint control before you would issue the bond. Is that correct? A. Yes, sir.

Q. As a matter of fact, is it not correct that you made known to the parties concerned that Century would require a joint control account before the bond was written? A. Yes, sir.

Q. And that is what was told to the Marine Development people. Is that correct? A. I presume so.

Q. Did you ever have any communication with the Marine Development Company people other than this letter? A. Well, that letter.

Q. Concerning what you would require? A. I may have, but I don't remember. I have met them. What was said at the time I do not remember.

Q. What would it be at variance with any thing you said in this letter? A. I am sure it would not be at variance, no, sir.

This requirement of taxpayer was consummated in the establishment of "White-Ahlgren Trust Account No. 1" at the Security Trust and Savings Bank of San Diego in December, 1953, at the time the bond was issued. (R. 82-83.) Of course, the purpose of the trust was to vest legal control of the funds earned under the subcontract in the taxpayer and this is exactly what was done.

The record shows that the instructions issued to the bank with regard to the trust account specifically so stated. The instructions, which were signed by repre-

sentatives of both taxpayer and White-Ahlgren, provided that *title* to the trust account and the funds therein was vested in trustees and attorneys in fact of the taxpayer to be held as security to the taxpayer. The precise language is as follows (Defendant's Exhibit "B", Appendix B, *infra*):

The title to said account, and any balance that may be therein at any time is hereby vested and declared to be held by the aforesaid Trustee and Attorneys in Fact of the Century Indemnity Company, as security to the Century Indemnity Company that all funds to the credit of said account at any time shall be used solely for the purpose of paying bills for labor and material and all obligations entering into a certain construction project with reference to the completion of which said The Century Indemnity Company has executed an Indemnity Bond.

The trustee or attorneys in fact of the account were carefully chosen to represent the interests of the taxpayer. Thus, Eva Cole, who was appointed as the original trustee and also as an attorney in fact, was an insurance agent doing business with the taxpayer company. Mr. Waite, one of the original attorneys in fact, was the manager of the taxpayer's bonding department at all pertinent times. Burton A. Van Tassel, a subsequent trustee signatory, was a lawyer retained by the taxpayer company. (R. 47-48.) All testified that when acting as trustee or attorney in fact over the trust account that they were acting on behalf of the taxpayer. (R. 130, 196, 239.)

Throughout the life of the subcontract, all of the payments made by Marine under the subcontract—and at

no time did White-Ahlgren receive any funds from any other job, contract or subcontract—were deposited directly into the trust account. (R. 83, 85.) All bank statements were sent to the taxpayer who later sent them to White-Ahlgren. (R. 308.)

Thus, taxpayer, as a condition precedent to the issuance of a bond, acquired legal title to and legal control of all funds earned under the subcontract. The taxpayer had absolute legal control.

As a result of the trust account arrangement, only taxpayer was in a position to effect compliance with the requirements under the Internal Revenue Code of withholding income taxes from the wages of employees. It was the taxpayer, as seen, who, through its representatives, held legal title to *all* funds earned under the subcontract; these amounts were the only sums available to or earned by White-Ahlgren throughout the period here involved; and these funds were controlled by trustees who concededly were acting on behalf of the taxpayer. Clearly, taxpayer falls squarely within the definition of “employer” in Section 1621(d)(1) for purposes of the withholding tax. It was the sole “person” in a position to comply with the requirement of withholding taxes on the employees wages since it alone had legal control of the funds to be used for payment of the wages. As we have shown, this is the precise situation contemplated by the statutory exception.

The facts of record further establish that the parties involved in the arrangement between White-Ahlgren and taxpayer, including taxpayer’s attorney, believed that the taxpayer was liable for the taxes here in question. Taxpayer’s attorney, Mr. Van Tassel, testified on cross-



examination by the District Director's attorney as follows (R. 276-277):

The Court: When you say that that was the only reason why this wasn't paid [the payroll taxes], you mean by that to express that in your opinion those taxes were due and payable out of that account, the payroll account, and not otherwise payable by White-Ahlgren?

The Witness: Your Honor's question isn't clear to me.

The Court: You said the only reason this check was not paid was because there wasn't sufficient money in the payroll account, the trustee account.

The Witness: In the trustee account.

The Court: And by that statement, do you mean to give it as your opinion that that is the only account from which those taxes could have been collected, or could they have been collected from other assets and property of White-Ahlgren?

The Witness: They might have been collected in part at least, I would guess, from other assets of White-Ahlgren. I hadn't any knowledge as to that at that time. My knowledge of the situation was restricted to what the trustee account itself revealed as to a checkbook or a bank balance.

This was all in the early stages, if your Honor please, when I was getting my feet wet on the job.

The Court: I understand. *The implication of your answer is that the only reason it wasn't paid is that there wasn't any money and that that account owed the money, and if you had control of the account you owed the money, if that is what you mean to say.*

The Witness: *That is what I mean to say*, that there was insufficient money in that account with which to meet those payroll taxes at that time and I therefore declined to countersign a check.

The Court: And that is the only reason the tax was not paid?

The Witness: Yes.

The Court: It looks to me like that is about the end of your lawsuit, Counsel.

Mr. Burford: I don't think so, your Honor.

The Court: I mean, if that is the only reason the tax wasn't paid then the tax was due out of that account. [Emphasis supplied.]

Indeed, the parties hardly could have reached a conclusion other than that the taxpayer assumed liability for the payroll taxes. With the brief exception of the period between December 7, 1953, and January 11, 1954, trustees for the taxpayer allowed payment out of the trust account for wages only of amounts sufficient to meet the *net* amount of the weekly payroll, *i.e.* the gross amount of wages less federal withholding, Federal Insurance Contributions Act taxes and state taxes. (R. 84-85.) Thus amounts attributable to payroll taxes remained in the trustee account under the legal title and control of taxpayer's representatives and were never available to White-Ahlgren for payment to the Government. The fact White-Ahlgren did not have control of the funds for payment to the Government is well illustrated by one occasion when White-Ahlgren's bookkeeper presented checks for federal and state payroll taxes to taxpayer's attorney Mr. Van Tassel (who was a trustee of the account) for his signature. Mr. Van Tassel refused to sign the checks for the amounts drawn or for any lesser amounts and, accordingly, the

taxes were not paid. Mrs. Higgins, White-Ahlgren's bookkeeper testified on direct-examination by the District Director's attorney as follows (R. 308-309):

Q. Now, Mrs. Higgins, directing your attention to on or about April 30, 1954, did you have occasion to discuss the payment of Federal withholding and employment taxes with Mr. Van Tassel?

A. Yes, sir.

Q. Would you please tell us what took place at that time? A. On this date, April 30th, I presented to Mr. Van Tassel a check for both the Federal and the State payroll taxes for his signature.

Q. By "payroll taxes with reference to the Federal taxes," do you mean the withholding and the employment taxes? A. I do.

Q. All right; please continue. A. I presented this check or, rather, two checks, one to the State and one to the Federal government, for his signature along with the reports.

Q. You mean the returns? A. The returns, yes.

Mr. Van Tassel told me at that time to mail in the returns but that we would be in a better position later on to sign these checks.

Q. Did he at that time sign any checks? A. The checks were not signed.

Q. Did he at that time indicate that if a check in a lesser amount were presented to him he would sign it? A. No, sir.

Q. Did he say anything further to you at that time? A. Not at that time.



Q. What did you then do? A. I mailed the returns.

Q. Without payment? A. Without payment.

Q. Did Mr. Van Tassel ever approve a check for payment thereafter? A. A check was never canceled it was never signed. Mr. White of White-Ahlgren testified that he at no time promised Mr. Van Tassel or any member of taxpayer that White-Ahlgren would pay the federal taxes. (R. 229.)

In actual fact, the taxpayer in this case was, through its legal control, using funds belonging to the United States Government to reduce its liability under the bond on which it was surety for White-Ahlgren. By using these funds to pay materials bills and other pressing debts instead of holding them for the rightful owner, the Government, the taxpayer avoided expenditures otherwise necessary out of its own pocket. This is a far different situation than existed in *Westover v. William Simpson Const. Co.*, 209 F. 2d 908 (C. A. 9th), and *Fireman's Fund Indemnity Co. v. United States*, 210 F. 2d 472 (C. A. 9th), upon which the taxpayer places particular reliance in its brief filed in this Court. In each of these cases, there was a mere loan or advance of sufficient monies to meet the net or "take-home" wages. None of the lenders were ever in a position to meet the withholding requirements of the Internal Revenue Code since none of them ever controlled funds which would have enabled them to do so.

Thus, in the *Simpson* case, when a subcontractor became financially embarrassed, the principal contractor

agreed to transfer sufficient funds to meet “take-home” pay. Actually the funds advanced had already been earned by the subcontractor and payment was simply accelerated. This Court said (p. 911):

The legislative history of §1621(d) makes it clear that something more than the mere supplying of the money for the payroll is essential.\* \* \*

In the *Fireman's Fund* case, which this Court decided on the basis of *Simpson*, the factual situation was substantially the same. There, the surety for a contractor advanced funds to the contractor (when it no longer had funds sufficient to carry on its work) which enabled it to meet net or “take-home” salaries of its employees. Paragraph XI of the stipulation of facts in that case provided as follows:

That only the net, or take-home pay, that is, the gross wages less the required deductions Federal unemployment taxes, Federal Insurance Contributions taxes and withholding taxes and other deductions, was at all times paid to the employees of Swedlow Engineering Co., Inc., during the periods in this stipulation mentioned.

This Court held, in effect, that the surety was simply a lender of the net amounts advanced, the same as the contractor in *Simpson*, and had no control over the payment of wages and certainly not over sums owing to the Government for withholding taxes. In like manner, *Phinney v. Southern Warehouse Corp.*, 212 F. 2d 488 (C. A. 5th).

In the instance case, on the contrary, as noted, the taxpayer had control of *all* the funds received from Marine under the subcontract and was not merely advancing sufficient sums to meet net payrolls.

With respect to *Reliance Insurance Co. v. United States* (N. D. Calif.), decided November 27, 1959 (60-1 U. S. T. C., par. 9315) also cited by taxpayer, since the opinion of the Court does not set forth a sufficient statement of facts, we can only assume in view of the Court's reliance on *Simpson* and *Southern Warehouse* that the facts there were similar to the facts in the cases relied upon. As shown, these cases have no application to the case at bar.

The decided cases most in point are *United States v. Fogarty*, 164 F. 2d 26 (C. A. 8th), *United States v. Curtis*, 198 F. 2d 268 (C. A. 6th), and *In re Daigle*, 111 Fed. Supp. 109 (S. D. Me.). These cases hold that a trustee in bankruptcy who makes payments in respect of wages earned by the bankrupt's employee before the bankruptcy is an employer for income withholding tax purposes. The trustees in those cases, as the trustee representatives of the taxpayer in the instant case, succeeded as trustees to the legal custody and control of the funds out of which payment was made and thus, under the statute, became liable to withhold income taxes on the wages paid out of the funds. The Court in *Fogarty* said (p. 32):

Although much of what has been said concerning the liability of the trustee for the employ-



ment taxes is applicable to the question of his liability for these taxes, the last quoted statutory provisions appear on their face to apply directly to the situation here where the company which employed the wage earners has gone into bankruptcy and lost control over the payment of the wages and its trustee succeeded to the custody and control of its assets and actually made the payment out of such assets. \* \* \* We think, \* \* \* that the trustee was the one in control of the payment of wages within the intent of Section 1621(d). The purpose is to treat the actual payor of the remuneration as the employer for withholding and payment purposes.

For the reasons stated, it is clear that the taxpayer in the instant case was in "control of the payment of the wages" within the meaning of Section 1621(d)(1) of the 1939 Code to employees engaged in a construction project subcontracted to White-Ahlgren throughout the entire period involved—*i.e.*, from December 7, 1953, to September 17, 1954—and thus is liable for federal income withholding taxes on the wages paid.

### Conclusion.

The District Court erred insofar as it held that taxpayer was not in "control of the payment of the wages", namely, for the period December 7, 1953, to March 7, 1954, and to this extent should be reversed. The District Court was correct insofar as it held that taxpayer was in "control of the payment of the wages",

namely, for the period March 8, 1954, to September 17, 1954, and to this extent should be affirmed.

Respectfully submitted,

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SHARON L. KING,  
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Washington 25, D. C.*

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RICHARD G. SHERMAN,  
*Assistant United States Attorney.*

February, 1962.









## APPENDIX A.

Internal Revenue Code of 1939:

SEC. 1621 [As added by Sec. 2(a) of the Current Tax Payment Act of 1943, c. 120, 57 Stat. 126].

### DEFINITIONS.

As used in this subchapter—

\* \* \*

(d) *Employer*.—The term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” (except for the purposes of subsection (a)) means the person having control of the payment of such wages; and

(a) in the case of a person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States, the term “employer” (except for the purposes of subsection (a)) means such person.

(26 U. S. C. 1952 ed., Sec. 1621.)

SEC. 1622 [As added by Sec. 2(a) of the Current Tax Payment Act of 1943, *supra*, and amended by Sec. 501 of the Revenue Act of 1948, c. 168, 62 Stat. 110, Sec. 141 of the Revenue Act of 1950, c. 994, 64 Stat. 906, and Sec. 201 of the Revenue Act of 1951, c. 521, 65 Stat. 452]. INCOME TAX COLLECTED AT SOURCE.



(a) *Requirement of Withholding.*—Every employer making payment of wages shall deduct and withhold upon such wages a tax equal to 18 per centum of the amount by which the wages exceed the number of withholding exemptions claimed multiplied by the amount of one such exemption as shown in subsection (b)(1), except that in the case of wages paid on or after November 1, 1951, and before January 1, 1954, the tax shall be equal to 20 per centum of such excess in lieu of 18 per centum.

\* \* \*

(26 U. S. C. 1952 ed., Sec. 1622.)

SEC. 1623 [As added by Sec. 2(a) of the Current Tax Payment Act of 1943, *supra*]. LIABILITY FOR TAX.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this subchapter, and shall not be liable to any person for the amount of any such payment.

(26 U. S. C. 1952 ed., Sec. 1623.)

Treasury Regulations 120 (1939 Code):

SEC. 406.205. *Employer.*—

(a) The term “employer” means any person for whom an individual performs or performed any service, of whatever nature, as the employee of such person.

(b) It is not necessary that the services be continuing at the time the wages are paid in order that the status of employer exist. Thus, for purposes of withholding, a person for whom an individual has performed past services for which he

is still receiving wages from such person is an “employer.”

(c) If the person for whom the services are or were performed does not have legal control of the payment of the wages for such services, the term “employer” means (except for the purpose of the definition of “wages”) the person having such control. For example, where wages, such as certain types of pensions or retired pay, are paid by a trust and the person for whom the services were performed has no legal control over the payment of such wages, the trust is the “employer.”

(d) The term “employer” also means (except for the purpose of the definition of “wages”) any person paying wages on behalf of a nonresident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States (including Puerto Rico as if a part of the United States).

(e) It is a basic purpose to centralize in the employer the responsibility for withholding, returning, and paying the tax and furnishing the statements required under section 1633. The foregoing two special definitions of the term “employer” are designed solely to meet unusual situations. They are not intended as a departure from the basic purpose.

(f) An employer may be an individual, a corporation, a partnership, a trust, an estate, a joint-stock company, an association, or a syndicate, group, pool, joint venture, or other unincorporated organization, group, or entity. A trust or estate, rather than the fiduciary acting for or on behalf of the trust or estate, is generally the employer.

(g) The term “employer” embraces not only individuals and organizations engaged in trade or business, but organizations exempt from income tax, such as religious and charitable organizations, educational institutions, clubs, social organizations and societies, as well as the governments of the United States, the States, Territories, Puerto Rico, and the District of Columbia, including their agencies, instrumentalities, and political subdivisions.

Treasury Regulations 120 apply only to the year 1954. Section 405.105 of Treasury Regulations 116 (1939 Code) which is applicable to the fourth quarter of 1953, also here involved, is in all essential respects the same as Section 406.205 of Treasury Regulations 120.



APPENDIX B.  
Defendant's Exhibit A.

November 16, 1953

Marine Development, Inc.  
302 Robinson Building  
San Diego 1, California

Re: White-Ahlgren Company, Inc. Subcontract  
for all concrete work.

Gentlemen:

White-Ahlgren Company, Inc. and your Company are now considering the execution of a contract for the construction of the concrete work as named above for the Title VIII Wherry Housing Project, Camp Pendleton, California, for the aggregate contract price of \$549,138.20.

White-Ahlgren Company, Inc. are not now sufficiently financed to permit us as surety to execute a bond for 100% of the job. It is anticipated that additional financing is to be invested in that corporation which, when received, will permit us to execute such a 100% bond.

We as surety do commit ourselves to a firm agreement that upon receipt of \$25,000.00 in cash by White-Ahlgren Company, Inc., which is anticipated to be put into the corporation on or before November 25, 1953 and an advance payment of \$10,000.00 by Marine Development, Inc. to White-Ahlgren Company, Inc. which specific sum of money is to be deposited in a special

bank account of White-Ahlgren Company, Inc., of which we as surety will have joint control, we agree that when said conditions have been met that we will issue to you a bond guaranteeing the performance and payment of labor and material bills in the amount of 100% of the contract price.

Very truly yours,

THE CENTURY INDEMNITY  
COMPANY

By D. J. Waite

Attorney In Fact

DJW :hg

Defendant's Exhibit B.

December 2, 1953

INSTRUCTIONS TO: SECURITY TRUST &  
SAVINGS BANK OF SAN DIEGO.

---

Name of bank

RE: WHITE-AHLGREN TRUST ACCOUNT  
NO. 1.

From time to time you will receive checks for credit to the above account which you will deposit to the credit of said account. You will permit withdrawals from said account only upon checks signed by White-Ahlgren Company, Inc. (Contractor) and countersigned by Eva L. Cole, Trustee, or upon checks signed by either D. J. Waite or Eva L. Cole or Frank D. Cole as Attorney-in-Fact of the Century Indemnity Company.

The title to said account, and any balance that may be therein at any time is hereby vested and declared to be held by the aforesaid Trustee and Attorneys in Fact of the Century Indemnity Company, as security to the Century Indemnity Company that all funds to the credit of said account at any time shall be used solely for the purpose of paying bills for labor and material and all obligations entering into a certain construction project with reference to the completion of which said The Century Indemnity Company has executed an Indemnity Bond.

Notwithstanding anything hereinbefore contained to the contrary, SECURITY TRUST & SAVINGS  
BANK OF SAN DIEGO is authorized to pay any

Name of bank

checks, drafts, or orders when signed as hereinabove provided, without inquiry in any case as to circum-



stances of their issue or the disposition of their proceeds, whether drawn to the individual order of, or tendered in payment of individual obligations of the persons above named or otherwise.

These instructions are being sent in triplicate, and your acknowledgment of their receipt on the two copies and their return to the Century Indemnity Company will be appreciated.

Attested by:

Irene Higgins

WHITE-AHLGREN COMPANY,  
INC.

By W. T. Ahlgren  
W. T. Ahlgren, President  
(Contractor)

Eva L. Cole  
Eva L. Cole (Trustee)  
THE SECURITY INDEMNITY  
COMPANY

By D. J. Waite  
D. J. Waite - Attorney-in-Fact  
By Eva L. Cole  
Eva L. Cole - Attorney-in-Fact  
By Frank D. Cole  
Frank D. Cole - Attorney-in-Fact

ABOVE ATTESTED TO:

SECURITY TRUST & SAVINGS BANK  
OF SAN DIEGO

M.E. FRAZIER 1/12/54

By H. P.

Title

No. 17354  
IN THE  
**United States Court of Appeals**  
FOR THE NINTH CIRCUIT

---

CENTURY INDEMNITY COMPANY, a corporation, *Appellant,*

*vs.*

ROBERT A. RIDDELL, District Director of Internal Revenue for the  
Los Angeles District of California, *Appellee,*

and

ROBERT A. RIDDELL, District Director of Internal Revenue for the  
Los Angeles District of California, *Appellant,*

*vs.*

CENTURY INDEMNITY COMPANY, a corporation, *Appellee.*

---

Reply Brief for Appellant and Cross-Appellee  
Century Indemnity Company.

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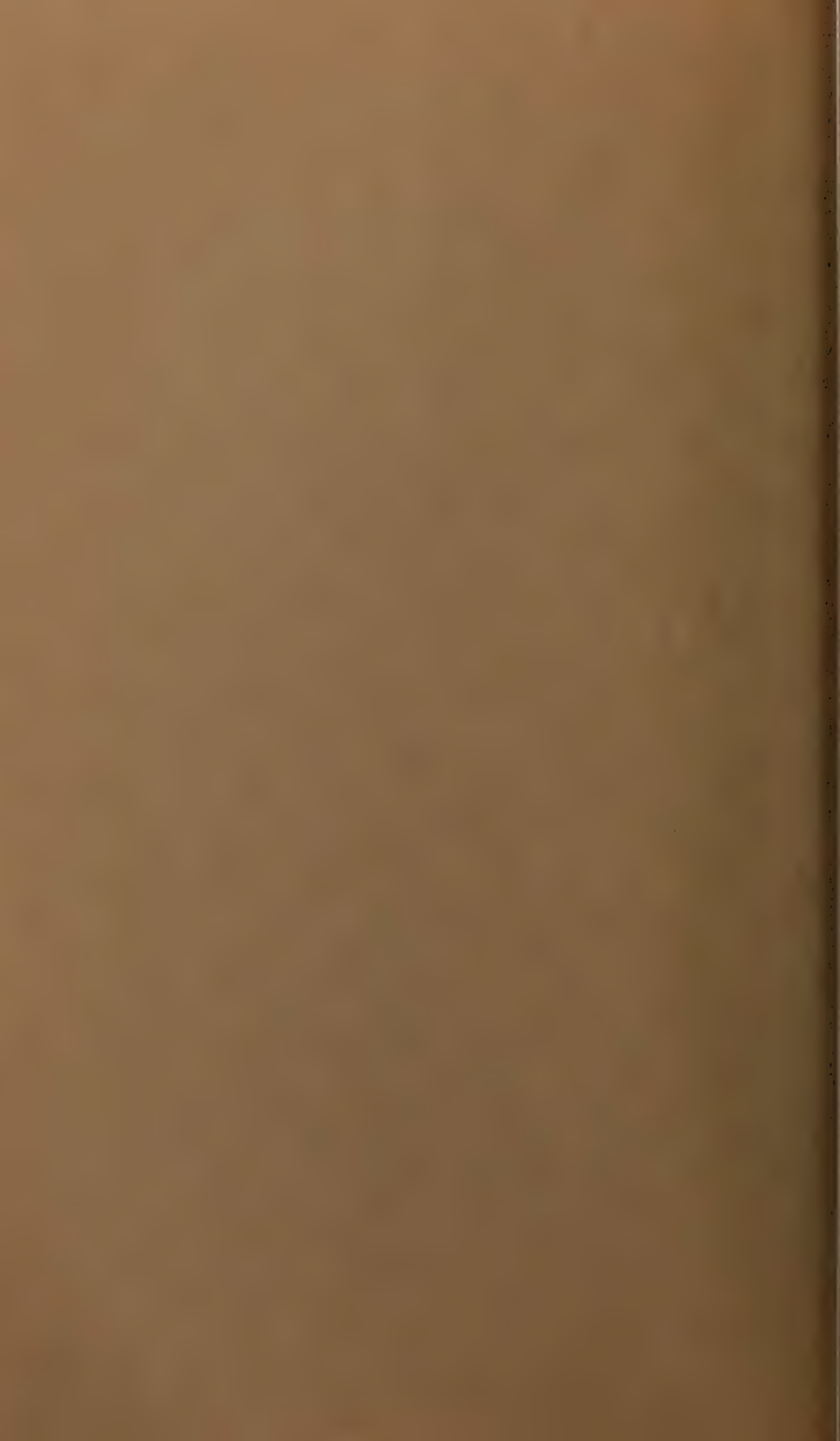
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Cross-Appellee.*

**FILED**

MAR - 6 1962

FRANK H. SCHMID, CLERK





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CENTURY INDEMNITY COMPANY, a corporation,  
*Appellant,*  
*vs.*  
ROBERT A. RIDDELL, District Director of Internal Revenue for the  
Los Angeles District of California,  
*Appellee,*  
and  
ROBERT A. RIDDELL, District Director of Internal Revenue for the  
Los Angeles District of California,  
*Appellant,*  
*vs.*  
CENTURY INDEMNITY COMPANY, a corporation,  
*Appellee.*

---

Reply Brief for Appellant and Cross-Appellee  
Century Indemnity Company.

---

**Statement.**

Although Taxpayer has no inclination or desire to be picayunish about the statement of facts in this case, which are in general stipulated or otherwise quite clear, in the interests of the record it appears that several points in the statements of facts as set forth in the brief for the District Director deserve comment as follows:

1. On page 6, it is stated that:

“The only job being performed by White-Ahlgren was the subcontract with Marine and at no time did White-Ahlgren receive any funds from any other job, contract or subcontract. [R. 83-85.]”



This statement apparently was taken from paragraph X of the Findings of Fact. [R. 84.] However, as that finding states, this referred to the period commencing March 9, 1954, and ending with the completion of the subcontract on September 17, 1954. As set forth in paragraph III (A)(12) of the Pre-Trial Conference Order [R. 51] White-Ahlgren [then named Wright-Ahlgren Company, Inc., see following paragraph (13)] had a contract with Webb-Knapp Company which had been entered into prior to the date of the contract here in question and on which work was still in progress on December 2, 1953, the date the surety bond was executed and the bank trust account was opened. All of White-Ahlgren's rights to payments under this contract were assigned to Taxpayer as of May 28, 1954. [R. 282.]

2. On page 7, the last sentence in the first paragraph reads:

“The checks were deposited in the White-Ahlgren general account and checks to the individual employees were drawn from this account. [R. 84, 314.]”

Presumably this was understood to cover the entire period between December 7, 1953, and March 8, 1954. However, there were in fact 148 checks dated between December 18, 1953, and January 12, 1954, in the total amount of \$9,630.18, payable to individual employees of White-Ahlgren, which were drawn not on the general account but on the trust account, signed by both Mr. Ahlgren and Mr. White, and which were honored by the bank without the required countersignature of a representative of Taxpayer. [Pltf. Ex. 36, R. 114-115.] This amount, in short, was improperly diverted. The testimony of Mrs. Cole is not entirely clear because of a discrepancy in dates. However, it appears obvious, and

it is believed to be a fair and reasonable inference from her testimony, that upon the discovery of this situation the procedure for handling payrolls was changed. Whereas, one payroll check for the gross payroll had theretofore been drawn on the trust account and deposited in the White-Ahlgren general account, thereafter one check for the net payroll was drawn on the trust account and deposited in the general account until March 9, 1954. [R. 110-117.]

3. On page 15 of the Director's brief the statement is made in the second paragraph that the evidence of record establishes that Taxpayer required the trust account as a condition precedent to its issuance of the bond. Again on page 17 it is stated that this requirement of Taxpayer was consummated in the establishment of "White-Ahlgren Trust Account No. 1".

Counsel for Taxpayer still fail to grasp the legal significance in this case of the motivation for the establishment of the joint control account since one was in fact established. The legal consequences flow from the fact—what was done—and not from why it was done.

However, since counsel for the Director apparently has consistently deemed the motivation for the establishment of the joint control account to be one of the significant factors in this case, the position of the Taxpayer should be made clear.

The Court below refused to find as a fact that Taxpayer required the opening of the "White-Ahlgren Trust Account No. 1" as a condition precedent to its issuance of the surety bond. The refusal of the Court to so find is alleged by counsel for the Director to be erroneous and is one of the points relied upon in his cross-appeal. [R. 336-337.]



It is submitted that the refusal of the Court below to make this finding is amply sustained by the record. Admittedly D. J. Waite, on behalf of Taxpayer, wrote the letter to the prime contractor stating the conditions under which the surety bond would be issued. [Deft. Ex. A, Appendix B of Director's brief.] This included the phrase "\* \* \* which specific sum of money is to be deposited in a special bank account of White-Ahlgren Company, Inc., of which we as surety will have joint control, \* \* \*." A joint control account was, of course, established.

However, what Government counsel obviously is attempting to establish is that Taxpayer would not have written the bond, absent the joint control requirement. In Taxpayer's view the letter [Deft. Ex. A] must be read in context. Mrs. Cole testified that Taxpayer did not require the joint control account but that Hertha Clausen, who was putting up some of the money, did. On cross-examination Mrs. Cole emphatically reaffirmed her testimony. [R. 101-104, 124.] Mr. Waite testified to the same effect, and specifically stated that the joint control was not an additional requirement of the surety company. [R. 187.] He also testified, as stated by Government counsel in the Director's brief, that he did adopt the suggestion of a joint-control account. [R. 195.] In short, the letter, when read in conjunction with the testimony, simply means that when certain things were done the bond would be issued. This is considerably different, it is submitted, from the interpretation placed on the letter by government counsel, namely, that unless a joint control account was established the bond would not be issued.



The refusal of the Court below to find that taxpayer *required* a joint control account as a *condition precedent* to its issuance of the surety bond is amply supported by the evidence. Unless and until this Court finds that the Court below erred in this regard, it is the understanding of counsel for the Taxpayer that the record, as now before this Court, is that the establishment of a joint control account was not a condition precedent to the issuance of the bond.

In his brief on pages 20 and 21 the Director makes much too broad an inference from the statement of the Court that the implication of Mr. Van Tassel's previous statement that there was not sufficient money in the trustee account to pay payroll taxes on a return prepared by White-Ahlgren was that the only reason it was not paid was that there wasn't any money and that the account owed the money, and if Century Indemnity had control of the account it owed the money, "if that is what you mean to say". The reply of Mr. Van Tassel was: "That is what I mean to say, that there was insufficient money in that account with which to meet those payroll taxes at that time and I therefore declined to countersign a check," and that was the only reason the tax was not paid. It is very important, however, to observe that prior to the above question by the Court and the answer by Mr. Van Tassel, the latter had said "They [the taxes] might have been collected in part at least, I would guess, from other assets of White-Ahlgren. I hadn't any knowledge as to that at that time. My knowledge of the situation was restricted to what the trustee account itself revealed as to a checkbook or a bank balance."

## ARGUMENT.

The Subcontractor, and Not Taxpayer, Had Control of the Payment of Wages and Was the "Employer" Within the Meaning of Section 1621(d) of the Internal Revenue Code of 1939 as Amended.

### A. Preliminary.

The sole issue now remaining on this appeal and cross-appeal involves liability for federal income withholding taxes, delinquency penalty and interest, for the fourth quarter of 1953 and the first three quarters of 1954. Two periods of time are involved.

1. The period December 7, 1953, to March 8, 1954. The District Court held that during this period Taxpayer did not have "control of the payment of the wages" of the employees of the subcontractor within the meaning of Section 1621(d)(1) of the 1939 Internal Revenue Code.

Cross-appellant, the District Director, contends that this holding is erroneous.

2. The period March 8, 1954, to September 17, 1954. The District Court held that during this period Taxpayer did have "control of the payment of the wages" of the employees of the subcontractor within the meaning of Section 1621(d)(1) of the 1939 Internal Revenue Code.

Appellant, the Taxpayer, contends that this holding is erroneous.

Cross-appellant, the District Director, necessarily directs his argument to the entire period, first to show error in the District Court's holding in favor of Taxpayer for the first period, and second to show the cor-

rectness of the District Court's holding in favor of the District Director for the second period.

With respect to the first period, for which Taxpayer here urges that the holding of the Court below be affirmed, a brief statement should suffice.

The record is clear that subcontractor had a general commercial bank account with which Taxpayer had no connection. [Pltf. Ex. 5, R. 312-313.] Beginning with the first payroll under the subcontract on December 7, 1953, and until January 11, 1954, a check in the gross amount of the weekly payroll on this subcontract was deposited in this account. For the period between January 12, 1954, and March 8, 1954, a check in the net amount of each payroll was deposited in this account. The money on deposit in this account was not under the control of Taxpayer in any shape, form or fashion. In addition, it is pointed out that subcontractor drew individual payroll checks on the trust account which were honored by the bank even though not properly countersigned. These checks covered the period from December 18, 1953; to January 12, 1954, and were in the total amount of \$9,630.18. [Pltf. Ex. 36, R. 114-115.] They should have been drawn on subcontractor's regular commercial account. The net effect of this was that a check for the payroll was deposited in subcontractor's commercial account, and individual payroll checks for the same payroll were also drawn on the trust account and cashed. [R. 200-201.]

Two points appear clear. During this period there was no control in fact over the payment of the wages of subcontractor's employees. If there were *legal* control of such payments, as urged by the Director, it is difficult to see upon what theory it can be urged that



it was exercised to his detriment and so as to prevent the subcontractor from paying the taxes in question.

Taxpayer will now direct its attention to two points which are the heart of the Government's argument. These points are as follows:

1. Did Taxpayer alone have legal control of the funds to be used for the payment of the wages?
2. Are the cases cited by Taxpayer controlling in this case?

**B. Taxpayer Alone Did Not Have Legal Control of the Funds to Be Used for the Payment of the Wages.**

In the District Director's brief a considerable portion of the argument is directed to an analysis of the evidence to show that Taxpayer required the establishment of "White-Ahlgren Trust Account No. 1" as a condition precedent to the issuance of the bond. This argument has been commented upon above and no useful purpose would be served by repeating it again here. It is next asserted that the statutory language "control of the payment of the wages" means legal control of such payments as pointed out in the Treasury Regulations [Treasury Regulations 120 (1939 Code), Section 406.205(c)], and that "the purpose of the trust was to vest legal control of the funds earned under the subcontract in the Taxpayer and this is exactly what was done." (Deft. Br. p. 17.)

Finding No. VI of the District Court [R. 83] is quoted here for the convenience of the Court:

"White-Ahlgren Company, Inc., opened a commercial checking account in the Security Trust and Savings Bank of San Diego, California, on December 2, 1953, which said account was known as

‘White-Ahlgren Trust Account No. 1,’ over which White-Ahlgren Company, Inc., and plaintiff, as surety, would have joint control. The resolutions and signature cards filed with the aforesaid bank required all checks drawn against said Trust Account No. 1 by an authorized signatory of White-Ahlgren Company, Inc., to be countersigned by any one of several designated representatives of plaintiff who was to sign as trustee.”

This finding states that subcontractor and Taxpayer, as surety, would have joint control over this account and that all checks drawn required an authorized signatory of subcontractor and the countersignature of any one of several designated representatives of Taxpayer who was to sign as trustee. This finding is not alleged to be erroneous by the District Director.

Title to said account and any balance therein was stated to be vested in and held by Taxpayer [Deft. Ex. B.] But for what purpose? The document plainly states:

“\* \* \* as security to the Century Indemnity Company that all funds to the credit of said account at any time shall be used *solely* for the purpose of paying bills for labor and material and all obligations entering into a certain construction project with reference to the completion of which said The Century Indemnity Company has executed an Indemnity Bond.” (Emphasis Supplied.)

The factual situation before this Court is this: A joint control account, which required checks to be signed by the subcontractor and countersigned by a representative of the Taxpayer was established. The purpose of this joint control account was to insure that moneys paid

subcontractor by the prime contractor and deposited in this account were used solely to meet obligations incurred in connection with this contract.

What were the legal consequences? Did this arrangement place Taxpayer in "control of the payment of the wages" in question within the meaning of § 1621(d)(1)? The answer is, No.

The District Director relies on *United States v. Fogarty*, 164 F. 2d 26 (C. A. 8th), *United States v. Curtis*, 198 F. 2d 268 (C. A. 6th), and *In re Daigle*, 111 Fed. Supp. 109 (S. D. Me.). These cases involved trustees in bankruptcy and, as stated in the District Director's brief (page 25), hold that the trustees succeeded to the legal custody and control of the funds of the bankrupt out of which payment for the wages in question were made. The trustee was thus in control of the payment of wages within the intent of Section 1621(d).

There are two fatal weaknesses in the position of the District Director and in his reliance on these cases.

First, on this record and the findings of the Court below, it simply cannot be said that Taxpayer succeeded to the legal custody and control of the funds in the joint control account in the sense of a trustee in bankruptcy. There is no such analogy. This remained a joint control account for the entire period here involved.

Second, this same argument was advanced by Government counsel in *Westover v. William Simpson Const. Co.*, 209 F. 2d 908 (9th Cir., 1954). On page 22 of Appellant's brief, which was filed with this Court, Government counsel stated:

"So far as the applicability of Section 1621(d)(1) of the Code is concerned, this case does not



differ materially from *United States. v. Fogarty*, 164 F. 2d 26 (C. A. 8th), and *United States v. Curtis*, 178 F. 2d 268 (C. A. 6th), certiorari denied, 339 U. S. 965. \* \* \*

This was also the argument of the Government in the District Court and on the appeal in *United States v. Swedlow Engineering Co.*, 100 Fed. Supp. 796 (S. D. Cal. 1951), reversed by this Court in a *per curiam* opinion, *sub. nom., Fireman's Fund Indemnity Co. v. United States*, 210 F. 2d 472 (9th Cir. 1954). The Court in the *Simpson* case, *supra*, did not even consider it necessary to discuss this contention in its opinion. It has been uniformly rejected.

If the rationale of the *Simpson* case applies here, it is evident that the portion of the judgment of the Court below adverse to Taxpayer should be reversed and the portion in favor of Taxpayer should be sustained. To render the exception to the definition of "employer" contained in § 1621(d)(1) applicable, two things must be shown: (1) that the subcontractor had no control over the payment of the wages and (2) that the Taxpayer had. Obviously this requirement was not met. Whatever measure of control Taxpayer had was *not exclusive* but was *shared* with the subcontractor. (See *Simpson, supra.*)

#### C. The Cases Cited by Taxpayer Are Controlling in This Case.

The Director, in his brief, states that the *Simpson*, *Fireman's Fund* and *Southern Warehouse* cases, cited by Taxpayer are not controlling here. Why? Because in those cases there was merely an advance or loan of funds for the purpose of meeting the "take home" pay of the contractor's employees. Here Taxpayer had

“control” of *all* the funds received under the subcontract and was not merely advancing sufficient funds to meet net payrolls. (Director’s Br. pp. 24-25.)

Is this really a sound distinction, and if so, is it controlling? It is respectfully submitted that both these questions must be answered in the negative.

Certainly this is not the position taken by the Government in those cases or the legal proposition there urged.

In the *Simpson* case the prime contractor agreed to meet the labor and material claims of a subcontractor as they fell due but only to the extent of the net amount due the laborers and materialmen. This was done through an acceleration of progress payments under the contract.

The money had been earned and when thus advanced belonged to the subcontractor. However, it was deposited in the name of the subcontractor in a “payroll trust account” which required the signature of a representative of the subcontractor, or the signature of only the prime contractor’s representative, acting for and at the request of the subcontractor. The purpose of this arrangement, of course, was to ensure that the money would be applied to meet net “takehome” pay of laborers and other lienable claims under the contract.

The purpose of the trust account in the case before this Court was solely to ensure that the money received under the contract would be applied in payment of the wages of laborers and of lienable claims connected with it. In *Simpson*, this Court said: “Indeed, it is doubtful whether Simpson-Kier had any control over the wage payments.” (P. 911.) This is interpreted by Taxpayer to mean that all Simpson-Kier did, by au-



thorizing its representative to sign checks on the account, was to see that the money was expended for the designated purposes, and that Simpson-Kier had no control over determining who the employees were, whether they should be paid, or how much. This is equally true of Taxpayer in the case now before this Court. The employees were all hired by the subcontractor, the payroll was prepared by it, and all Taxpayer did was to verify that the payroll checks corresponded with the actual payroll sheets before countersigning the checks. Certainly it had no discretion in the matter.

Next the Director urges that the *Simpson* rule does not apply here because Taxpayer, the bonding company, did not “loan or advance” money to the subcontractor as in the *Fireman’s Fund* and *Reliance Insurance Co.* cases. Taxpayer did pay lienable claims under the contract of some \$119,000.00 [Pltf. Ex. 20] and effected recoveries of some \$70,723.64 [R. 67], leaving a net payment by Taxpayer of over \$48,000.00. On the Director’s theory, as understood by Taxpayer, the *Simpson* case would control here had Taxpayer “advanced” money to the subcontractor for payroll purposes and subcontractor had expended the money in the trust account for payment of other lienable claims, to wit, materialmen. However, if the converse procedure were followed, that is the money in the trust account were used to pay wages and the bonding company advanced money to pay materialmen the legal effect is entirely different. Simply to state the proposition is to demonstrate its fallacy. In all these cases there is one simple fact. Whatever the reason there simply is not enough money to go around. Who, then, is liable for the federal income withholding taxes?



Under the statutory exception to the definition of the term “employer” contained in § 1621(d)(1), it is clear, as stated in the Conference Report, that “If the wages are paid by a person other than the person for whom the services are or were performed, the term ‘employer’ means the *person paying such wages.* \* \* \*” [Conf. Rep. No. 510, 78th Congress, 1st Session, 1943 Cum. Bull. 1351, 1353.] (Emphasis supplied.) Were the wages here in question paid by a person other than the person for whom the services were performed? Did Taxpayer have the measure of control of the wage payments required of the statutory exception? It is respectfully submitted that the answer is clearly, No.

### Conclusion.

On the appeal of the Taxpayer, Century Indemnity Company, it is again submitted that the District Court’s decision was in error in holding that the Taxpayer was the “employer” of the employees of the subcontractor between March 9, 1954, and September 17, 1954, within the meaning of Sections 1621(d), 1622(a) and 1623 of the Internal Revenue Code of 1939, as amended, and that the Taxpayer was entitled to take nothing with respect to Withholding taxes and interest paid by the Taxpayer to Defendant for this period. This portion of the decision should be reversed. The remainder of the decision should be affirmed. It will be noted that on page 3 of his brief the Director states the holding of the District Court that judgment for re-

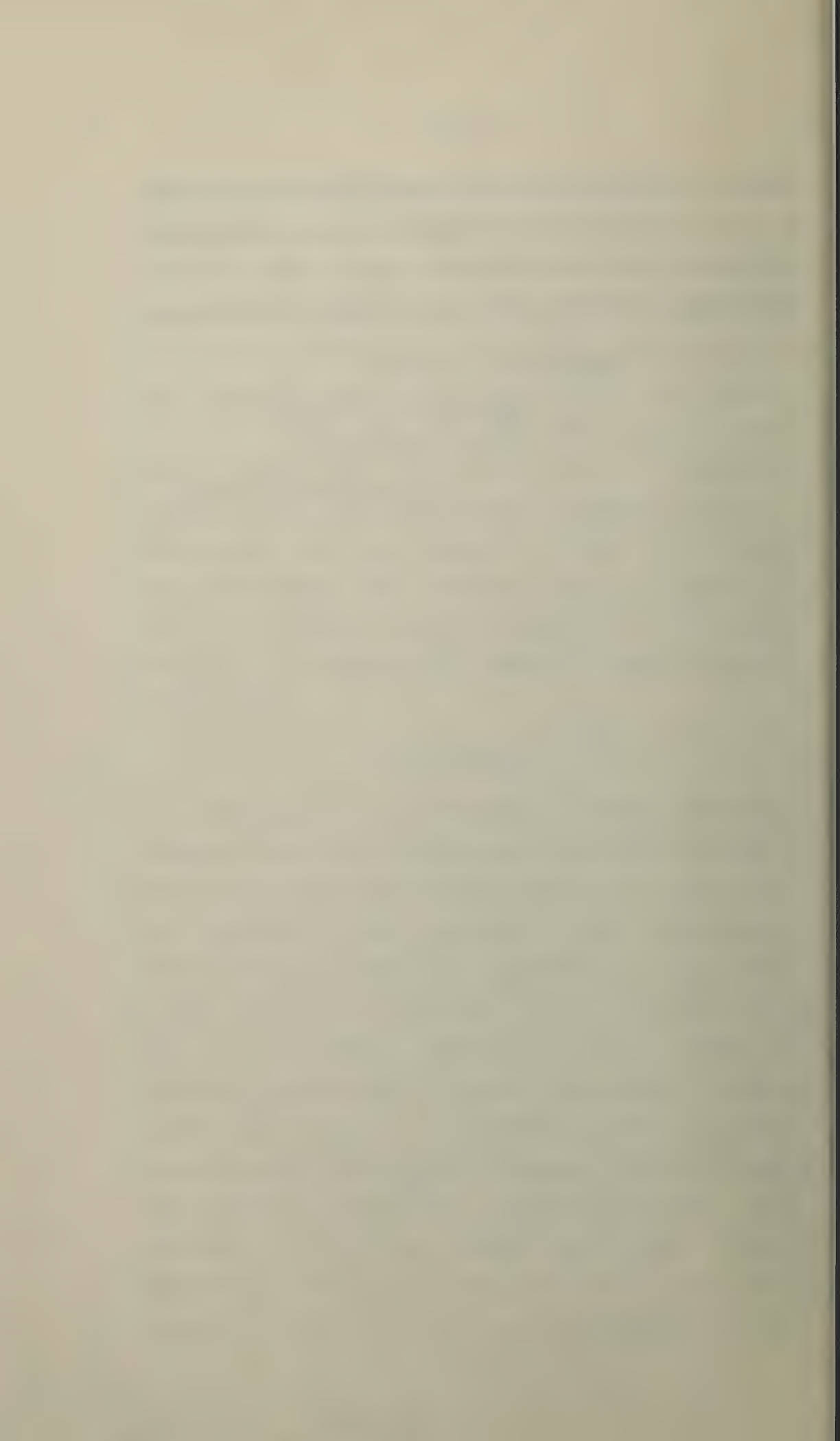
fund to Taxpayer of the FICA and FUTA taxes which it had paid to the District Director is not contested on appeal, and that the Director's appeal with respect to the taxing of costs in the District Court is withdrawn.

Respectfully submitted,

ARTHUR H. DEIBERT,

A. L. BURFORD, JR.,

*Attorneys for Taxpayer.*





No. 17354

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**United States  
Court of Appeals  
For the Ninth Circuit**

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CENTURY INDEMNITY COMPANY,  
Appellant,  
vs.  
ROBERT A. RIDDELL, etc.,  
Appellee,  
and  
ROBERT A. RIDDELL, etc.,  
Appellant,  
vs.  
CENTURY INVESTMENT CO.,  
Appellee.

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**Transcript of Record**

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**Appeals from the United States District Court for the  
Southern District of California  
Central Division**

FILED

NOV - 6 1961

FRANK H. SUTTER, JR.



No. 17354

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United States  
Court of Appeals  
For the Ninth Circuit

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CENTURY INDEMNITY COMPANY,  
Appellant,  
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Transcript of Record

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Appeals from the United States District Court for the  
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THE  
JOURNAL OF THE  
ROYAL ANTHROPOLOGICAL INSTITUTE

Volume 1

Part I

1871

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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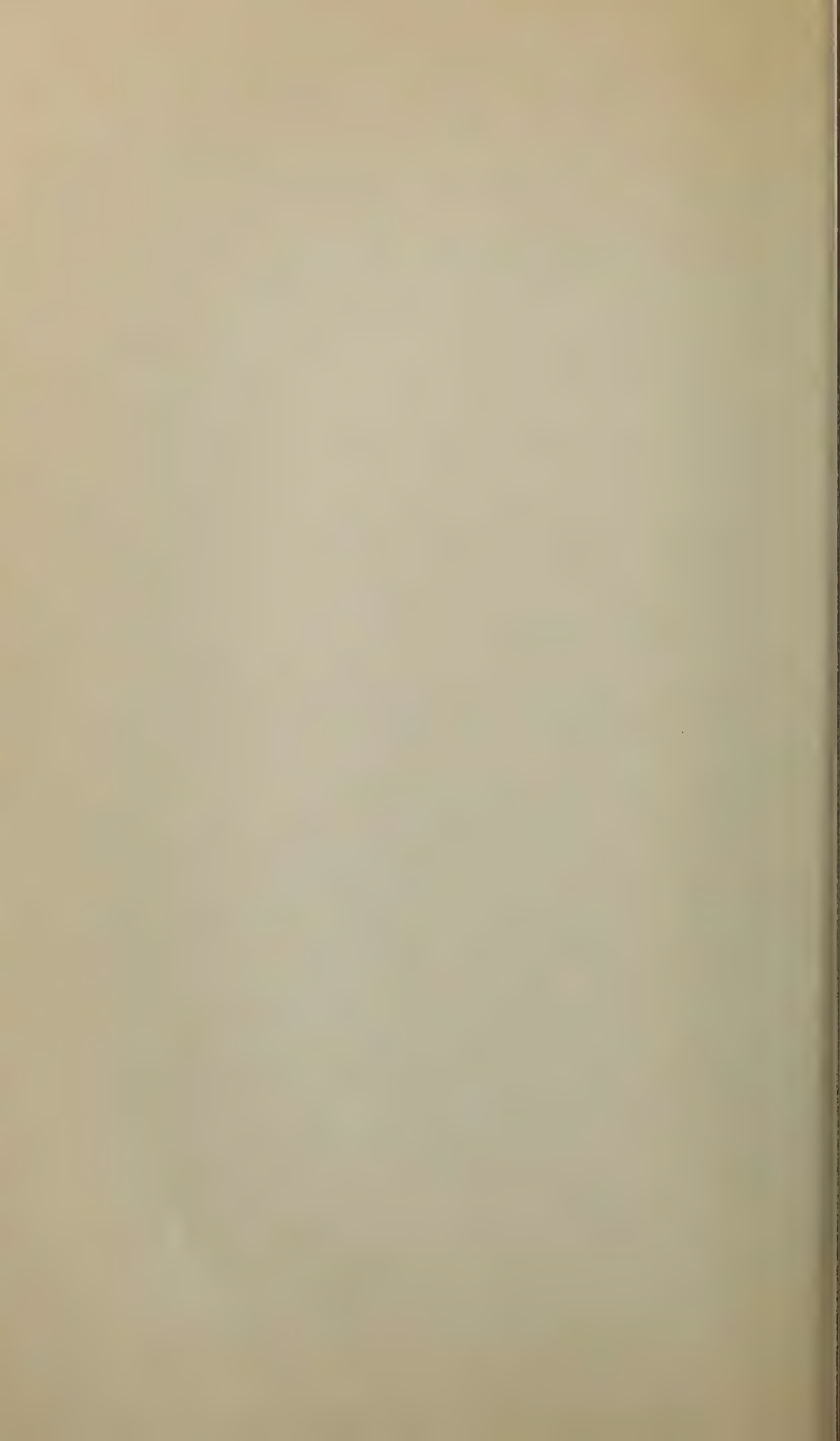
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In the District Court of the United States in and for  
the Southern District of California, Central Di-  
vision

Civil No. 959-58-PH

THE CENTURY INDEMNITY COMPANY, a  
Corporation,

Plaintiff,

vs.

ROBERT A. RIDDELL, District Director of In-  
ternal Revenue for the Los Angeles District of  
California,

Defendant.

COMPLAINT TO RECOVER FEDERAL WITH-  
HOLDING TAX ON WAGES; TAX UNDER  
THE FEDERAL INSURANCE CONTRIBU-  
TIONS ACT, AND TAX UNDER FEDERAL  
UNEMPLOYMENT TAX ACT, ALL ILLE-  
GALLY ASSESSED AND COLLECTED

Comes now the Plaintiff, The Century Indemnity  
Company, and alleges as follows:

First Cause of Action

I.

Plaintiff, The Century Indemnity Company, is,  
and at all times herein mentioned was, a corporation  
organized and existing under and by virtue of the  
laws of the State of Connecticut, duly qualified to  
transact business in the State of California, and  
having its principal place of business and office in

the State of California at 220 Bush Street, San Francisco, California, and a branch office at 548 South Spring Street, Los Angeles, California.

## II.

Defendant is now and at all times since the 26th day of November, [2\*] 1952, has been the duly appointed, qualified and acting District Director of Internal Revenue for the Los Angeles District of California. Defendant is the person to whom the tax withheld on wages, together with a delinquency penalty, the tax under the Federal Insurance Contributions Act, and the tax under the Federal Unemployment Tax Act, together with interest thereon, the sums herein sought to be recovered, were paid, under protest, by the Plaintiff, as hereinafter set forth. At all times herein mentioned, defendant was and still is a resident of the County of Los Angeles, State of California, and of said Southern District of California, Central Division.

## III.

Jurisdiction of this Court exists under Title 28, United States Code, Section 1340, and under Section 3772(a)(2) of the 1939 Internal Revenue Code or Section 6532(a)(1) of the 1954 Internal Revenue Code, and Section 7422(a) of the 1954 Internal Revenue Code.

## IV.

On October 6, 1953, the White-Ahlgren Company, Inc., hereinafter referred to as "White-Ahlgren,"

---

**\*Page numbering appearing at foot of page of original Certified Transcript of Record.**

entered into a subcontract with Marine Development, Inc., hereinafter referred to as "Marine Development," to do and complete all concrete work as outlined in Section G, Concrete Work, and Section H, Concrete Curb, Concrete Sidewalks and Sidewalk Steps, in the Specifications and all plans pertaining thereto for the 1,000 Unit Wherry Housing Projects, F.H.A. Projects 129-80007 and 129-80008, and Navy Projects N-09A, Section 1, and N-09A, Section 2, at Camp Pendleton, California. Work under the said subcontract did not, however, commence until on or about December 7, 1953. This subcontract, except for certain modifications as hereinafter set forth, continued in full force and effect until its completion by White-Ahlgren on or about September 17, 1954. A true and correct copy of said subcontract is attached hereto as Exhibit "A," and is incorporated herein by reference as if fully set forth herein.

#### V.

On or about October 6, 1953, White-Ahlgren made a written [3] Application to Plaintiff for a Contract Bond and Agreement of Indemnity in the amount of White-Ahlgren's said subcontract with Marine Development, viz., \$549,138.20. A true and correct copy of said Application is attached hereto as Exhibit "B," and is incorporated herein by reference as if fully set forth herein. On or about December 2, 1953, a Surety Bond described as Contract Bond No. 291379 was executed by and on behalf of White-Ahlgren as Principal and The Century Indemnity Company, Plaintiff herein, as Surety, and naming



Marine Development as Owner, and Republic National Bank of Dallas, Texas, as Mortgagee, as required by the laws of the State of California as contained in Sections 1183, et seq., Code of Civil Procedure and all acts amendatory thereof, said bond to inure to the benefit of persons performing labor or furnishing materials, appliances, teams or power contributing to the work described in the aforesaid subcontract. A true and correct copy of said Contract Bond is attached hereto as Exhibit "C" and is incorporated herein by reference as if fully set forth herein.

## VI.

On or about December 2, 1953, White-Ahlgren opened a commercial checking account in the Security Trust & Savings Bank of San Diego, California, known as White-Ahlgren Trust Account No. 1, for the purpose of receiving funds from Marine Development in payment for work performed or to be performed under the aforesaid subcontract between White-Ahlgren and Marine Development, and from other sources, and to have such funds transferred from said Trust Account No. 1 from time to time to a general account which White-Ahlgren opened in the said Bank on or about December 10, 1953. Checks to be drawn by White-Ahlgren against said Trust Account No. 1 for the payment of wages by White-Ahlgren to its employees under the aforesaid subcontract with Marine Development were subject to countersignature; that is, each check was supposed to be signed by either Albert C. White or W. T. Ahlgren on behalf of White-Ahlgren, and by

any one of several designated representatives of Plaintiff, who was to sign as Trustee. However, through error on the part of [4] White-Ahlgren, the net wages of employees of White-Ahlgren were paid to them out of said Trust Account No. 1, on behalf of White-Ahlgren, on the signature of either W. T. Ahlgren or Albert C. White alone, and without any countersignature by any representative of Plaintiff, for each of the payrolls of White-Ahlgren for the periods ending December 14, 1953, to and including January 4, 1954. Also, during December, 1953, and the first and second quarters of 1954, certain transfers of funds were made from said Trust Account No. 1 to the general account of White-Ahlgren, both carried in the said Security Trust & Savings Bank of San Diego, California, to cover certain wage payments made by White-Ahlgren to its employees under the aforesaid subcontract. No such wage payment checks drawn on said general account of White-Ahlgren for the weekly payroll periods January 11, 1954, to March 8, 1954, or for any other periods, were required to be or were countersigned by any representative of Plaintiff. Beginning with the payroll period ended March 15, 1954, and ending with the completion of its subcontract on or about September 17, 1954, wage payments were made directly from the aforesaid Trust Account No. 1 to employees of White-Ahlgren on checks signed by either Albert C. White or W. T. Ahlgren and a representative of Plaintiff as Trustee. On or about May 28, 1954, a general account was opened by White-Ahlgren in a branch of said Security Trust & Sav-



ings Bank of San Diego, at Carlsbad, California, with funds transferred thereto from said Trust Account No. 1, for the purpose of enabling White-Ahlgren to make termination wage payments to its employees working on the said subcontract with Marine Development at Camp Pendleton, California. Checks on the said Carlsbad general account were not required to be and were not countersigned by any representative of Plaintiff.

#### VII.

On December 2, 1953, at the request of White-Ahlgren, Marine Development made a loan to White-Ahlgren representing an advance of \$10,000.00 against future progress payments under the aforesaid subcontract, and that amount was deposited on the same day in the aforesaid [5] Trust Account No. 1.

#### VIII.

During the month of March, 1954, it was agreed by and between Marine Development and White-Ahlgren that the latter was approximately 75 units behind the construction rate called for in the aforesaid subcontract. White-Ahlgren gave as the main reason for this delay the fact that it had insufficient working capital to proceed at the rate called for in the subcontract. On or about March 22, 1954, an agreement was reached between Marine Development and White-Ahlgren under which a less exacting performance schedule was set up for White-Ahlgren to complete its said subcontract, and in addition Marine Development agreed to accelerate



progress payments to White-Ahlgren so that they would be made weekly instead of monthly, as provided in said subcontract. It was further agreed that otherwise the said subcontract and the surety bond furnished by Plaintiff should remain in full force and effect, and they did until said subcontract was completed by White-Ahlgren on or about September 17, 1954, as aforesaid. Said subcontract was never cancelled.

### IX.

Said subcontract provided that 10 per cent of the subcontract price was to be retained by Marine Development until the subcontract was completed.

Beginning with the loan against future progress payments by Marine Development to White-Ahlgren on December 2, 1953, in the amount of \$10,000.00, Marine Development paid to White-Ahlgren Trust Account No. 1, to and including September 3, 1954, the date of the last payment, the total sum of \$496,882.55. From the original contract price of \$549,138.20, there were deducted \$518.40, representing cost of a retaining wall deleted from the subcontract, and back charges by Marine Development in the amount of \$1,862.35, but there were added certain extras over and above the original contract price in the amount of \$4,374.28, making a total of \$551,131.73. Deducting the aforesaid total payments by Marine Development to White-Ahlgren of \$496,882.55, left a [6] balance of \$54,249.18, which amount was paid by Marine Development to Plaintiff on December 17, 1954. Said latter amount was so paid

by virtue of the provisions of the aforesaid Contract Bond, under which also Plaintiff had been required to pay to creditors of White-Ahlgren for labor and materials furnished to White-Ahlgren the approximate sum of \$119,188.17.

X.

White-Ahlgren filed with Defendant a delinquent withholding tax return for the fourth quarter of 1953, but filed timely withholding tax returns for the first, second and third quarters of 1954, after which no wage payments were made by White-Ahlgren, but did not pay the taxes shown thereon to be due from it. Prior to October 6, 1953, on which date Marine Development and White-Ahlgren entered into a subcontract for work at Camp Pendleton, California, as aforesaid, White-Ahlgren, under its prior name of Wright-Ahlgren Company, Inc., had made a contract with the Webb-Knapp Company of San Diego, California, providing for the installation of cement slabs, curbs, etc., in a housing project at San Diego, California, and work under that contract was in progress on December 2, 1953. It appeared that White-Ahlgren might be able to satisfy its tax liability for both withholding and social security taxes to the Federal Government under its said Marine Development subcontract out of profits from the said Webb-Knapp contract by the time tax returns for both the first and second quarters of 1954 were due to be filed by White-Ahlgren with the Defendant; also that White-Ahlgren might have available funds for the payment of its said taxes

out of a claim then pending against Marine Development for certain cement slabs for the floors of garages required under the said subcontract, but eventually White-Ahlgren lost money on the said Webb-Knapp contract, and its said claim against Marine Development was disallowed.

## XI.

On August 22, 1956, Defendant made assessments against White-Ahlgren and Plaintiff jointly of combined Withholding and Federal Insurance Contributions Act taxes and penalties for the fourth quarter of [7] 1953 and for the first, second, and third quarters of 1954, as follows:

Taxable Period	Amount Assessed
WT:FICA	T \$ 754.15
4Q53	P 188.54
WT:FICA	T 9,911.00
1Q54	P 2,477.75
WT:FICA	T 14,810.10
2Q54	P 3,702.53
WT:FICA	T 4,759.19
3Q54	P 1,189.80

## XII.

Thereafter, Defendant issued three 10-day Notices and Demands, each dated August 27, 1956, for payment for the fourth quarter of 1953, and the second and third quarters of 1954, respectively, addressed to:

“White Ahlgren Co. &  
Century Indemnity Co.,  
7405 Alvarado Freeway,  
La Mesa, Calif.”;



in each case for "Income tax withheld from wages and FICA taxes," as follows:

		4Q53	
Assessment			Balance Due
\$	754.15		
P	188.54		\$ 942.69
			Int. 118.63
			<hr/>
			\$ 1,061.32
		2Q54	
	\$14,810.10		
P	3,702.53		\$18,512.63
			Int. 1,830.68
			<hr/>
			\$20,343.31
		3Q54	
	\$ 4,759.19		
P	1,189.80		\$ 5,948.99
			Int. 516.90
			<hr/>
			\$ 6,465.89

Defendant also issued a 10-day Notice and Demand for payment, dated August 27, 1956, addressed as follows: [8]

"White-Ahlgren Co., Inc.,  
Century Indemnity Co.,  
c/o Walter T. Ahlgren,  
7405 Alvarado Freeway,  
LaMesa, Calif.

"(Name added to assessment list per memo 9/27/56)"

for "Income tax withheld from wages and FICA taxes," as follows:

1Q54

Assessment	Balance Due
\$ 9,911.00	
P 2,477.75	\$12,388.75
	Int. 1,375.45
	<hr/>
	\$13,764.20

## XIII.

Pursuant to the foregoing 10-day Notices and Demands for combined "Withholding and FICA taxes," and after segregating the amounts for withholding taxes alone, Plaintiff, under protest, paid to Defendant on November 12, 1957, the following withholding taxes, delinquency penalty, and interest to November 12, 1957:

Period	Tax	Delinquency	
		Penalty	Interest
4th Quarter, 1953.....	\$ 649.22	\$162.31	\$ 159.33
1st Quarter, 1954.....	6,977.35	.....	1,479.00
2nd Quarter, 1954.....	10,662.98	.....	2,100.31
3rd Quarter, 1954.....	3,403.85	.....	619.41

## XIV.

Plaintiff was not and never has been the "employer" of the employees of White-Ahlgren, the subcontractor, within the meaning of Section 1621(d) (1) of the 1939 Internal Revenue Code, or any other provision of law, and was not and never has been liable for withholding of tax on wages of employees of White-Ahlgren under the provisions of Section 1622 of the 1939 Internal Revenue Code, or any other provision of law. Accordingly, the withholding taxes herein sought to be recovered were not due from Plaintiff, and were therefore illegally assessed, demanded and collected from Plaintiff by Defend-

ant. Plaintiff, pursuant to the aforesaid Notices and Demands, has overpaid tax withheld in wages, including penalty and interest, for the 4th quarter of 1953, and the 1st, [9] 2nd and 3rd quarters of 1954, in the amount of \$26,213.76, which should be refunded.

### XV.

Pursuant to the provisions of Section 322(b)(1) of the 1939 Internal Revenue Code, and/or Section 6511(a) of the 1954 Internal Revenue Code, Plaintiff filed with Defendant, within the period allowed by law, a proper claim for refund of said tax, penalty, and interest in the amount of \$26,213.76, assessed by Defendant and paid by Plaintiff as aforesaid. A true copy of said claim for refund is attached hereto, marked Exhibit "D," and incorporated herein by reference as if fully set forth herein. No action has been taken by Defendant, by the Commissioner of Internal Revenue, or by the Secretary or his delegate with respect to said claim, and no part of said tax, penalty, or interest alleged to have been illegally assessed and collected and thus overpaid has been refunded or credited to Plaintiff. More than six months' time has expired from the date of filing said claim. [10]

### Second Cause of Action

#### I.

Plaintiff, The Century Indemnity Company, is, and at all times herein mentioned was, a corporation organized and existing under and by virtue of the laws of the State of Connecticut, duly qualified



to transact business in the State of California, and having its principal place of business and office in the State of California at 220 Bush Street, San Francisco, California, and a branch office at 548 South Spring Street, Los Angeles, California.

II.

Defendant is now and at all times since the 26th day of November, 1952, has been the duly appointed, qualified and acting District Director of Internal Revenue for the Los Angeles District of California. Defendant is the person to whom the tax withheld on wages, together with a delinquency penalty, the tax under the Federal Insurance Contributions Act, and the tax under the Federal Unemployment Tax Act, together with interest thereon, the sums herein sought to be recovered, were paid, under protest, by the Plaintiff, as hereinafter set forth. At all times herein mentioned, Defendant was and still is a resident of the County of Los Angeles, State of California, and of said Southern District of California, Central Division.

III.

Jurisdiction of this Court exists under Title 28, United States Code, Section 1340, and under Section 3772(a)(2) of the 1939 Internal Revenue Code or Section 6532(a)(1) of the 1954 Internal Revenue Code, and Section 7422(a) of the 1954 Internal Revenue Code.

IV.

On October 6, 1953, the White-Ahlgren Company, Inc., hereinafter referred to as "White-Ahlgren,"

entered into a subcontract with Marine Development Company, Inc., hereinafter referred to as "Marine Development," to do and complete all Concrete Work as outlined in Section G, Concrete Work, and Section H, Concrete Curb, Concrete Sidewalks and Sidewalk Steps, in the Specifications and all plans pertaining [11] thereto for the 1,000 Unit Wherry Housing Projects, F.H.A. Projects 129-80007 and 129-80008, and Navy Projects N-09A, Section 1, and N-09A, Section 2, at Camp Pendleton, California. Work under the said subcontract did not, however, commence until on or about December 7, 1953. This subcontract, except for certain modifications as hereinafter set forth, continued in full force and effect until its completion by White-Ahlgren on or about September 17, 1954. A true and correct copy of said subcontract is attached hereto as Exhibit "A," and is incorporated herein by reference as if fully set forth herein.

#### V.

On or about October 6, 1953, White-Ahlgren made a written Application to Plaintiff for a Contract Bond and Agreement of Indemnity in the amount of White-Ahlgren's said subcontract with Marine Development, viz., \$549,138.20. A true and correct copy of said Application is attached hereto as Exhibit "B," and is incorporated herein by reference as if fully set forth herein. On or about December 2, 1953, a surety bond described as Contract Bond No. 291379 was executed by and on behalf of White-Ahlgren as Principal and The Century Indemnity



Company, Plaintiff herein, as Surety, and naming Marine Development as Owner, and Republic National Bank of Dallas, Texas, as Mortgagee, as required by the laws of the State of California as contained in Sections 1183, et seq., Code of Civil Procedure and all acts amendatory thereof, said bond to inure to the benefit of persons performing labor or furnishing materials, appliances, teams or power contributing to the work described in the aforesaid subcontract. A true and correct copy of said Contract Bond is attached hereto as Exhibit "C" and is incorporated herein by reference as if fully set forth herein.

## VI.

On or about December 2, 1953, White-Ahlgren opened a commercial checking account in the Security Trust & Savings Bank of San Diego, California, known as White-Ahlgren Trust Account No. 1, for the purpose of receiving funds from Marine Development in payment for work [12] performed or to be performed under the aforesaid subcontract between White-Ahlgren and Marine Development, and from other sources, and to have such funds transferred from said Trust Account No. 1 from time to time to a general account which White-Ahlgren opened in the said bank on or about December 10, 1953. Checks to be drawn by White-Ahlgren against said Trust Account No. 1 for the payment of wages by White-Ahlgren to its employees under the aforesaid subcontract with Marine Development were subject to countersignature; that is, each check was sup-



posed to be signed by either Albert C. White or W. T. Ahlgren on behalf of White-Ahlgren, and by any one of several designated representatives of Plaintiff, who was to sign as Trustee. However, through error on the part of White-Ahlgren, the net wages of employees of White-Ahlgren were paid to them out of said Trust Account No. 1, on behalf of White-Ahlgren, on the signature of either W. T. Ahlgren or Albert C. White alone, and without any countersignature by any representative of Plaintiff, for each of the payrolls of White-Ahlgren for the periods ending December 14, 1953, to and including January 4, 1954. Also, during December, 1953, and the first and second quarters of 1954, certain transfers of funds were made from said Trust Account No. 1 to the general account of White-Ahlgren, both carried in the said Security Trust & Savings Bank of San Diego, to cover certain wage payments made by White-Ahlgren to its employees under the aforesaid subcontract. No such wage payment checks drawn on said general account of White-Ahlgren for the weekly payroll periods January 11, 1954, to March 8, 1954, or for any other periods, were required to be or were countersigned by any representative of Plaintiff. Beginning with the payroll period ended March 15, 1954, and ending with the completion of its subcontract on or about September 17, 1954, wage payments were made directly from the aforesaid Trust Account No. 1 to employees of White-Ahlgren on checks signed by either Albert C. White or W. T. Ahlgren and a representative of Plaintiff as Trustee. On or about May 28, 1954, a gen-

eral account was opened by White-Ahlgren in a branch of said Security Trust & Savings Bank of San Diego, at [13] Carlsbad, California, with funds transferred thereto from said Trust Account No. 1, for the purpose of enabling White-Ahlgren to make termination wage payments to its employees working on the said subcontract with Marine Development at Camp Pendleton, California. Checks on the said Carlsbad general account were not required to be and were not countersigned by any representative of Plaintiff.

#### VII.

On December 2, 1953, at the request of White-Ahlgren, Marine Development made a loan to White-Ahlgren representing an advance of \$10,000.00 against future progress payments under the aforesaid subcontract, and that amount was deposited on the same day in the aforesaid Trust Account No. 1.

#### VIII.

During the month of March, 1954, it was agreed by and between Marine Development and White-Ahlgren that the latter was approximately 75 units behind the construction rate called for in the aforesaid subcontract. White-Ahlgren gave as the main reason for this delay the fact that it had insufficient working capital to proceed at the rate called for in the subcontract. On or about March 22, 1954, an agreement was reached between Marine Development and White-Ahlgren under which a less exacting performance schedule was set up for White-Ahlgren to complete its said subcontract, and in



addition Marine Development agreed to accelerate progress payments to White-Ahlgren so that they would be made weekly instead of monthly, as provided in said subcontract. It was further agreed that otherwise the said subcontract and the surety bond furnished by Plaintiff should remain in full force and effect, and they did until said subcontract was completed by White-Ahlgren on or about September 17, 1954, as aforesaid. Said subcontract was never cancelled.

### IX.

Said subcontract provided that 10 per cent of the subcontract price was to be retained by Marine Development until the subcontract was completed. [14]

Beginning with the loan against future progress payments by Marine Development to White-Ahlgren on December 2, 1953, in the amount of \$10,000.00, Marine Development paid to White-Ahlgren Trust Account No. 1, to and including September 3, 1954, the date of the last payment, the total sum of \$496,882.55. From the original contract price of \$549,138.20, there were deducted \$518.40, representing cost of a retaining wall deleted from the subcontract, and back charges by Marine Development in the amount of \$1,862.35, but there were added certain extras over and above the original contract price in the amount of \$4,374.28, making a total of \$551,131.73. Deducting the aforesaid total payments by Marine Development to White-Ahlgren of \$496,882.55, left a balance of \$54,249.18, which amount was paid by Marine Development to Plaintiff on December 17, 1954. Said latter amount was so paid by



virtue of the provisions of the aforesaid Contract Bond, under which also Plaintiff had been required to pay to creditors of White-Ahlgren for labor and materials furnished to White-Ahlgren the approximate sum of \$119,188.17.

### X.

White-Ahlgren filed with Defendant timely Federal Insurance Contributions Act tax returns for the fourth quarter of 1953 and for the first, second and third quarters of 1954, after which no wage payments were made by White-Ahlgren, but did not pay the taxes shown thereon to be due from it. Prior to October 6, 1953, on which date Marine Development and White-Ahlgren entered into a subcontract for work at Camp Pendleton, California, as aforesaid, White-Ahlgren, under its prior name of Wright-Ahlgren Company, Inc., had made a contract with the Webb-Knapp Company of San Diego, California, providing for the installation of cement slabs, curbs, etc., in a housing project at San Diego, California, and work under that contract was in progress on December 2, 1953. It appeared that White-Ahlgren might be able to satisfy its tax liability for both withholding and social security taxes to the Federal Government under its said Marine Development subcontract out of profits [15] from the said Webb-Knapp contract by the time tax returns for both the first and second quarters of 1954 were due to be filed by White-Ahlgren with the Defendant; also that White-Ahlgren might have available funds for the payment of its said taxes out of a claim

then pending against Marine Development for certain cement slabs for the floors of garages required under the said subcontract, but eventually White-Ahlgren lost money on the said Webb-Knapp contract, and its said claim against Marine Development was disallowed.

### XI.

On August 22, 1956, Defendant made assessments against White-Ahlgren and Plaintiff jointly of combined Withholding and Federal Insurance Contributions Act taxes and penalties for the fourth quarter of 1953 and for the first, second and third quarters of 1954, as follows:

Taxable Period	Amount Assessed
WT:FICA	T \$ 754.15
4Q53	P 188.54
WT:FICA	T 9,911.00
1Q54	P 2,477.75
WT:FICA	T 14,810.10
2Q54	P 3,702.53
WT:FICA	T 4,759.19
3Q54	P 1,189.80

### XII.

Thereafter, Defendant issued three 10-Day Notices and Demands, each dated August 27, 1956, for payment for the fourth quarter of 1953, and the second and third quarters of 1954, respectively, addressed to:

“White-Ahlgren Co. &  
Century Indemnity Co.,  
7405 Alvarado Freeway,  
La Mesa, Calif.;

in each case for "Income tax withheld from wages and FICA taxes," as follows:

4Q53		
Assessment		Balance Due
\$ 754.15		
P 188.54		\$ 942.69
		Int. 118.63
		<hr/>
		\$ 1,061.32
2Q54		
\$14,810.10		
P 3,702.53		\$18,512.63
		Int. 1,830.68
		<hr/>
		\$20,343.31
3Q54		
\$4,759.19		
P 1,189.80		\$5,948.99
		Int. 516.90
		<hr/>
		\$6,465.89

Defendant also issued a 10-Day Notice and Demand for payment dated August 27, 1956, addressed as follows:

"White-Ahlgren Co., Inc., & Century Indemnity Co.

c/o Walter T. Ahlgren,  
7405 Alvarado Freeway,  
La Mesa, Calif.

"(Name added to assessment list per memo 9/27/56)"

for "Income tax withheld from wages and FICA taxes," as follows:



1Q54

Assessment	Balance Due
\$9,911.00	
P 2,477.75	\$12,388.75
	Int. 1,375.45
	<hr/>
	\$13,764.20

**XIII.**

Pursuant to the foregoing 10-Day Notices and Demands for combined "Withholding and FICA taxes," and after segregating the amounts for Federal Insurance Contributions Act taxes alone, Plaintiff, under protest, paid to Defendant on November 12, 1957, the following FICA taxes, delinquency penalty, and interest to November 12, 1957:

Period	Tax	Delinquency Penalty	Interest
4th Quarter, 1953.....	\$ 104.93	\$26.23	\$ 25.75
1st Quarter, 1954.....	2,933.65	.....	621.85
2nd Quarter, 1954.....	4,147.12	.....	816.87
3rd Quarter, 1954.....	1,355.34	.....	246.63

**XIV.**

Section 1410 of the 1939 Internal Revenue Code provides for the [17] payment of an excise tax by employers under the Federal Insurance Contributions Act, but imposes such tax only upon an employer "having individuals in his employ." Plaintiff did not have in its employ those persons actually employed by White-Ahlgren, who are the only "individuals" involved in this tax. Accordingly the Federal Insurance Contributions Act taxes herein sought to be recovered were not due from Plaintiff, and were therefore illegally assessed, demanded

and collected from Plaintiff by Defendant. Plaintiff, pursuant to the aforesaid Notices and Demands, has overpaid Federal Insurance Contributions Act taxes, including penalty and interest, for the 4th quarter of 1953, and the 1st, 2nd and 3rd quarters of 1954, in the amount of \$10,278.37, which should be refunded.

### XV.

Pursuant to the provisions of Section 322(b)(1) of the 1939 Internal Revenue Code and/or Section 6511(a) of the 1954 Internal Revenue Code, Plaintiff, filed with Defendant, within the period allowed by law, a proper claim for refund of said tax, penalty, and interest in the amount of \$10,278.37, assessed by Defendant and paid by Plaintiff as aforesaid. A true copy of said claim for refund is attached hereto, marked Exhibit "E," and incorporated herein by reference as if fully set forth herein. No action has been taken by Defendant, by the Commissioner of Internal Revenue, or by the Secretary or his delegate with respect to said claim, and no part of said tax, penalty, or interest alleged to have been illegally assessed and collected and thus overpaid has been refunded or credited to Plaintiff. More than six months' time has expired from the date of filing said claim. [18]

### Third Cause of Action

#### I.

Plaintiff, The Century Indemnity Company, is, and at all times herein mentioned was, a corporation

organized and existing under and by virtue of the laws of the State of Connecticut, duly qualified to transact business in the State of California, and having its principal place of business and office in the State of California at 220 Bush Street, San Francisco, California, and a branch office at 548 South Spring Street, Los Angeles, California.

## II.

Defendant is now and at all times since the 26th day of November, 1952, has been the duly appointed, qualified and acting District Director of Internal Revenue for the Los Angeles District of California. Defendant is the person to whom the tax withheld on wages, together with a delinquency penalty, the tax under the Federal Insurance Contributions Act, and the tax under the Federal Unemployment Tax Act, together with interest thereon, the sums herein sought to be recovered, were paid, under protest, by the Plaintiff, as hereinafter set forth. At all times herein mentioned, defendant was and still is a resident of the County of Los Angeles, State of California, and of said Southern District of California, Central Division.

## III.

Jurisdiction of this Court exists under Title 28, United States Code, Section 1340, and under Section 3772(a)(2) of the 1939 Internal Revenue Code or Section 6532(a)(1) of the 1954 Internal Revenue Code, and Section 7422(a) of the 1954 Internal Revenue Code.



## IV.

On October 6, 1953, the White-Ahlgren Company, Inc., hereinafter referred to as "White-Ahlgren," entered into a subcontract with Marine Development, Inc., hereinafter referred to as "Marine Development," to do and complete all concrete work as outlined in Section G, Concrete Work, and Section H, Concrete Curb, Concrete Sidewalks and Sidewalk Steps, in the Specifications and all plans pertaining thereto for [19] the 1,000 Unit Wherry Housing Projects, F.H.A. Projects 129-80007 and 129-80008, and Navy Projects N-09A, Section 1, and N-09A, Section 2, at Camp Pendleton, California. Work under the said subcontract did not, however, commence until on or about December 7, 1953. This subcontract, except for certain modifications as hereinafter set forth, continued in full force and effect until its completion by White-Ahlgren on or about September 17, 1954. A true and correct copy of said subcontract is attached hereto as Exhibit "A," and is incorporated herein by reference as if fully set forth herein.

## V.

On or about October 6, 1953, White-Ahlgren made a written Application to Plaintiff for a Contract Bond and Agreement of indemnity in the amount of White-Ahlgren's said subcontract with Marine Development, viz., \$549,138.20. A true and correct copy of said Application is attached hereto as Exhibit "B," and is incorporated herein by reference as if fully set forth herein. On or about December 2, 1953, a Surety Bond described as Contract Bond No.

291379 was executed by and on behalf of White-Ahlgren as Principal and The Century Indemnity Company, Plaintiff herein, as Surety, and naming Marine Development as Owner, and Republic National Bank of Dallas, Texas, as Mortgagee, as required by the laws of the State of California as contained in Sections 1183, et seq., Code of Civil Procedure, and all acts amendatory thereof, said bond to inure to the benefit of persons performing labor or furnishing materials, appliances, teams or power contributing to the work described in the aforesaid subcontract. A true and correct copy of said Contract Bond is attached hereto as Exhibit "C" and is incorporated herein by reference as if fully set forth herein.

## VI.

On or about December 2, 1953, White-Ahlgren opened a commercial checking account in the Security Trust & Savings Bank of San Diego, California, known as White-Ahlgren Trust Account No. 1, for the purpose of receiving funds from Marine Development in payment for work performed [20] or to be performed under the aforesaid subcontract between White-Ahlgren and Marine Development, and from other sources, and to have such funds transferred from said Trust Account No. 1 from time to time to a general account which White-Ahlgren opened in the said Bank on or about December 10, 1953. Checks to be drawn by White-Ahlgren against said Trust Account No. 1 for the payment of wages by White-Ahlgren to its employees under the afore-



said subcontract with Marine Development were subject to countersignature; that is, each check was supposed to be signed by either Albert C. White or W. T. Ahlgren on behalf of White-Ahlgren, and by any one of several designated representatives of Plaintiff, who was to sign as Trustee. However, through error on the part of White-Ahlgren, the net wages of employees of White-Ahlgren were paid to them out of said Trust Account No. 1, on behalf of White-Ahlgren, on the signature of either W. T. Ahlgren or Albert C. White alone, and without any countersignature by any representative of Plaintiff, for each of the payrolls of White-Ahlgren for the periods ending December 14, 1953, to and including January 4, 1954. Also, during December, 1953, and the first and second quarters of 1954, certain transfers of funds were made from said Trust Account No. 1 to the general account of White-Ahlgren, both carried in the said Security Trust & Savings Bank of San Diego, California, to cover certain wage payments made by White-Ahlgren to its employees under the aforesaid subcontract. No such wage payments checks drawn on said general account of White-Ahlgren for the weekly payroll periods January 11, 1954, to March 8, 1954, or for any other periods, were required to be or were countersigned by any representative of Plaintiff. Beginning with the payroll period ended March 15, 1954, and ending with the completion of its subcontract on or about September 17, 1954, wage payments were made directly from the aforesaid Trust Account No. 1 to employees of White-Ahlgren on checks signed by either



Albert C. White or W. T. Ahlgren and a representative of Plaintiff as Trustee. On or about May 28, 1954, a general account was opened by White-Ahlgren in a branch of said Security Trust & Savings Bank of San Diego, at Carlsbad, California, with [21] funds transferred thereto from said Trust Account No. 1, for the purpose of enabling White-Ahlgren to make termination wage payments to its employees working on the said subcontract with Marine Development at Camp Pendleton, California. Checks on the said Carlsbad general account were not required to be and were not countersigned by any representative of Plaintiff.

#### VII.

On December 2, 1953, at the request of White-Ahlgren, Marine Development made a loan to White-Ahlgren representing an advance of \$10,000.00 against future progress payments under the aforesaid subcontract, and that amount was deposited on the same day in the aforesaid Trust Account No. 1.

#### VIII.

During the month of March, 1954, it was agreed by and between Marine Development and White-Ahlgren that the latter was approximately 75 units behind the construction rate called for in the aforesaid subcontract. White-Ahlgren gave as the main reason for this delay the fact that it had insufficient working capital to proceed at the rate called for in the subcontract. On or about March 22, 1954, an agreement was reached between Marine Develop-

ment and White-Ahlgren under which a less exacting performance schedule was set up for White-Ahlgren to complete its said subcontract, and in addition Marine Development agreed to accelerate progress payments to White-Ahlgren so that they would be made weekly instead of monthly, as provided in said subcontract. It was further agreed that otherwise the said subcontract and the surety bond furnished by Plaintiff should remain in full force and effect, and they did until said subcontract was completed by White-Ahlgren on or about September 17, 1954, as aforesaid. Said subcontract was never cancelled.

#### IX.

Said subcontract provided that 10 per cent of the subcontract price was to be retained by Marine Development until the subcontract was [22] completed.

Beginning with the loan against future progress payments by Marine Development to White-Ahlgren on December 2, 1953, in the amount of \$10,000.00, Marine Development paid to White-Ahlgren Trust Account No. 1, to and including September 3, 1954, the date of the last payment, the total sum of \$496,882.55. From the original contract price of \$549,138.20, there were deducted \$518.40, representing cost of a retaining wall deleted from the subcontract, and back charges by Marine Development in the amount of \$1,862.35, but there were added certain extras over and above the original contract price in the amount of \$4,374.28, making a total

of \$551,131.73. Deducting the aforesaid total payments by Marine Development to White-Ahlgren of \$496,882.55, left a balance of \$54,249.18, which amount was paid by Marine Development to Plaintiff on December 17, 1954. Said latter amount was so paid by virtue of the provisions of the aforesaid Contract Bond, under which also Plaintiff had been required to pay to creditors of White-Ahlgren for labor and materials furnished to White-Ahlgren the approximate sum of \$119,188.17.

#### X.

White-Ahlgren filed with Defendant a timely Federal Unemployment Tax Act tax return for the calendar year 1954, but did not pay the tax shown thereon to be due from it, inasmuch as its aforesaid subcontract had been completed and it had no funds for the payment of such tax.

#### XI.

On August 22, 1956, Defendant made assessments against White-Ahlgren and Plaintiff jointly of Federal Unemployment Tax Act taxes for the year 1954, in the amount of \$3,524.84 and delinquency penalty of \$881.21.

#### XII.

Thereafter, on August 27, 1956, Defendant issued a 10-Day Notice and Demand for payment of said Federal Unemployment Tax Act taxes for the year 1954 of \$3,524.84, together with delinquency penalty of \$881.21, and interest of \$329.96, a total of \$4,736.01, addressed [23] as follows:



“White Ahlgren Co. Inc. c/o Walter T. Ahlgren, 7405 Alvarado Freeway, La Mesa, Calif., and Century Indemnity Co.

(Name added to assessment list per memo 9/27/56)”

### XIII.

Pursuant to the aforesaid 10-Day Notice and Demand for payment of said Federal Unemployment Tax Act taxes, penalty, and interest for the year 1954, Plaintiff, under protest, paid to Defendant on November 12, 1957, the amount of \$4,113.39, made up of tax of \$3,524.84 and interest to date of payment of \$588.55. In the meantime the penalty had been removed by Defendant.

### XIV.

Section 1600 of the 1939 Internal Revenue Code provides for the payment of an excise tax by employers under the Federal Unemployment Tax Act, but imposes such tax only upon an employer “as defined in Section 1607(a) \* \* \* having individuals in his employ \* \* \*.” Section 1607(a) defines the term “employer” to be one who has individuals in his employment “Who were employed by him.” Inasmuch as Plaintiff did not have in its employ those persons actually employed by White-Ahlgren, who are the only “individuals” involved in this tax, the aforesaid sum of \$4,113.39 was not due from Plaintiff, and was therefore illegally assessed, demanded and collected from Plaintiff by Defendant, and should be refunded.

## XV.

Pursuant to the provisions of Section 322(b)(1) of the 1939 Internal Revenue Code and/or Section 6511(a) of the 1954 Internal Revenue Code, Plaintiff filed with Defendant, within the period allowed by law, a proper claim for refund of said tax and interest in the amount of \$4,113.39, assessed by Defendant and paid by Plaintiff as aforesaid. A true copy of said claim for refund is attached hereto, marked Exhibit "F," and incorporated herein by reference as if fully set forth herein. No action has been taken by Defendant, by the Commissioner of Internal Revenue, or by the Secretary or his delegate with respect to said claim, and no part of [24] said tax or interest alleged to have been illegally assessed and collected and thus overpaid has been refunded or credited to Plaintiff. More than six months' time has expired from the date of filing said claim.

Wherefore, plaintiff prays judgment against Defendant:

(a) For Withholding Tax on Wages, delinquency penalty, and interest, paid by Plaintiff to Defendant in the amount of \$26,213.76, plus interest as provided by law; and

(b) For tax, delinquency penalty, and interest under the Federal Insurance Contributions Act, paid by Plaintiff to Defendant in the amount of \$10,278.37, plus interest as provided by law; and

(c) For tax and interest under the Federal Unemployment Tax Act, paid by Plaintiff to Defendant in the amount \$4,113.39, plus interest as provided by law; and

(d) For Plaintiff's costs and disbursements herein and such other relief as the Court may deem meet and proper.

/s/ ARTHUR H. DEIBERT,  
Attorney for Plaintiff.

[Endorsed]: Filed October 7, 1958. [25]

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[Title of District Court and Cause.]

### ANSWER

Defendant, by its attorney, Laughlin E. Waters, United States Attorney for the Southern District of California, for its answer to plaintiff's complaint:

#### First

Denies each and every allegation of such complaint not admitted, qualified, or otherwise specifically referred to below.

#### Second

#### First Cause of Action

##### I.

Admits the allegations contained in paragraph 1 of plaintiff's complaint.



## II.

Admits the allegations contained in paragraph 2 of plaintiff's complaint, but denies the validity of each and every ground upon which plaintiff bases the present suit for refund of taxes, and avers that plaintiff is not entitled to recover any sums paid for taxes. [71]

## III.

Admits the allegations contained in paragraph 3 of plaintiff's complaint.

## IV.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 4 of plaintiff's complaint.

## V.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 5 of plaintiff's complaint.

## VI.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 6 of plaintiff's complaint.

## VII.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 7 of plaintiff's complaint.

VIII.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 8 of plaintiff's complaint.

IX.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 9 of plaintiff's complaint.

X.

Admits that White-Ahlgren filed with Defendant a delinquent withholding tax return for the fourth quarter of 1953, but denies that timely withholding tax returns were filed for the first, second and third quarters of 1954, and states that it is presently without sufficient information to form a belief as to the truth of the remaining allegations in the first [72] sentence of paragraph 10 of plaintiff's complaint. States that it is presently without sufficient information to form a belief as to the truth of the remaining allegations contained in paragraph 10 to plaintiff's complaint.

XI.

Admits the allegations contained in paragraph 11 of plaintiff's complaint.

XII.

Admits the allegations contained in paragraph 12 of plaintiff's complaint, but states that it is presently without sufficient information to form a belief as

to the truth of the allegations with respect to the manner in which said Notices and Demands were addressed.

### XIII.

Admits the allegations contained in paragraph 13 of plaintiff's complaint.

### XIV.

Denies each and every allegation contained in paragraph 14 of plaintiff's complaint.

### XV.

Admits the allegations contained in paragraph 15 of plaintiff's complaint, but denies that assessment and collection of taxes from plaintiff was in any manner illegal, and further denies the validity of each and every ground upon which plaintiff's claim for refund is based, and except as herein otherwise specifically admitted, denies the truth of each and every allegation contained therein.

## Second Cause of Action

### I.

Admits the allegations contained in paragraph 1 of plaintiff's complaint.

### II.

Admits the allegations contained in paragraph 2 of plaintiff's complaint, but denies the validity of each and every ground upon which [73] plaintiff bases the present suit for refund of taxes, and avers



that plaintiff is not entitled to recover any sums paid for taxes.

III.

Admits the allegations contained in paragraph 3 of plaintiff's complaint.

IV.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 4 of plaintiff's complaint.

V.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 5 of plaintiff's complaint.

VI.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 6 of plaintiff's complaint.

VII.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 7 of plaintiff's complaint.

VIII.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 8 of plaintiff's complaint.

## IX.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 9 of plaintiff's complaint.

## X.

Denies that White-Ahlgren filed timely Federal Insurance Contributions [74] Act tax returns for the fourth quarter of 1953 and for the first, second, and third quarters of 1954, and states that it is presently without sufficient information to form a belief as to the truth of the remaining allegations in the first sentence of paragraph 10 of plaintiff's complaint. States that it is presently without sufficient information to form a belief as to the truth of the remaining allegations contained in paragraph 10 of plaintiff's complaint.

## XI.

Admits the allegations contained in paragraph 11 of plaintiff's complaint.

## XII.

Admits the allegations contained in paragraph 12 of plaintiff's complaint, but states that it is presently without sufficient information to form a belief as to the truth of the allegations with respect to the manner in which said Notices and Demands were addressed.

## XIII.

Admits the allegations contained in paragraph 13 of plaintiff's complaint.

XIV.

Denies each and every allegation contained in paragraph 14 of plaintiff's complaint.

XV.

Admits the allegations contained in paragraph 15 of plaintiff's complaint, but denies that assessment and collection of taxes from plaintiff was in any manner illegal, and further denies the validity of each and every ground upon which plaintiff's claim for refund is based, and except as herein otherwise specifically admitted, denies the truth of each and every allegation contained therein.

Third Cause of Action

I.

Admits the allegations contained in paragraph 1 of plaintiff's complaint. [75]

II.

Admits the allegations contained in paragraph 2 of plaintiff's complaint, but denies the validity of each and every ground upon which plaintiff bases the present suit for refund of taxes, and avers that plaintiff is not entitled to recover any sums paid for taxes.

III.

Admits the allegations contained in paragraph 3 of plaintiff's complaint.

IV.

States that it is presently without sufficient knowledge to form a belief as to the truth of the



allegations contained in paragraph 4 of plaintiff's complaint.

V.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 5 of plaintiff's complaint.

VI.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 6 of plaintiff's complaint.

VII.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 7 of plaintiff's complaint.

VIII.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 8 of plaintiff's complaint.

IX.

States that it is presently without sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 9 of plaintiff's complaint. [76]

X.

Defendant admits that White-Ahlgren filed a Federal Unemployment Tax Act tax return for the calendar year 1954, and did not pay the tax shown thereon to be due from it, but denies that such re-

turn was filed timely, and further states that it is presently without sufficient knowledge to form a belief as to the truth of the allegations with respect to the reasons for such non-payment.

XI.

Admits the allegations contained in paragraph 11 of plaintiff's complaint.

XII.

Admits the allegations contained in paragraph 12 of plaintiff's complaint, but states that it is presently without sufficient information to form a belief as to the truth of the allegations with respect to the manner in which said Notice and Demand was addressed.

XIII.

States that it is presently without sufficient information to form a belief as to the truth of the allegations contained in the first sentence of paragraph 13 of plaintiff's complaint. Admits the allegations contained in the second sentence of paragraph 13 of plaintiff's complaint.

XIV.

Denies each and every allegation contained in paragraph 14 of plaintiff's complaint.

XV.

Admits the allegations contained in paragraph 15 of plaintiff's complaint, but denies that assessment and collection of taxes from plaintiffs was in any

manner illegal, and further denies the validity of each and every ground upon which plaintiff's claim for refund is based, and except as herein otherwise specifically admitted, denies the truth of each and every allegation contained therein. [77]

Wherefore, having fully answered, defendant prays that judgment be rendered in its favor, that defendant be awarded its costs, and that plaintiff take nothing by this action.

LAUGHLIN E. WATERS,  
United States Attorney;

EDWARD R. McHALE,  
Assistant U. S. Attorney,  
Chief, Tax Division;

EUGENE N. SHERMAN,  
Assistant U. S. Attorney,

/s/ EUGENE N. SHERMAN,  
Attorneys for Defendant.

Certificate of service by mail attached.

[Endorsed]: Filed December 8, 1958. [78]

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[Title of District Court and Cause.]

#### PRE-TRIAL CONFERENCE ORDER

Following pre-trial proceedings pursuant to Rule 16 of the Federal Rules of Civil Procedure and Local Rule 9 of this Court, It Is Ordered:



I. This is an action for:

The refund of (a) Withholding taxes, (b) Federal Insurance Contributions Act taxes, and (c) Federal Unemployment Act taxes paid under protest by Plaintiff to Defendant on November 12, 1957, in the aggregate [130] amount of \$40,607.02. The parties are shown above. The pleadings which raise the issues herein consist of a Complaint filed October 7, 1958, by Plaintiff, and an Answer filed December 8, 1958, by Defendant.

II. Federal jurisdiction exists under Section 1340 of Title 28, United States Code, which provides that the District Courts of the United States shall have original jurisdiction of any civil action arising under any Act of Congress providing for Internal Revenue, and the present action does so arise. Section 3772(a)(2) of the Internal Revenue Code of 1939 and Section 6532(a)(1) of the Internal Revenue Code of 1954, which are essentially identical, together with Section 7422(a) of the Internal Revenue Code of 1954, provide for suits for refund of taxes, penalties, and interest alleged to have been illegally collected, and provide also that no such suit or proceeding, after a claim for refund has been filed, shall be begun before the expiration of six months from the date of filing such claims unless the Commissioner of Internal Revenue renders a decision thereon within such time, nor after the expiration of two years from the date of mailing by the Commissioner to the taxpayer of a notice of disallowance of the part of the claim to which the

suit relates. A proper separate claim for refund for each of the three types of taxes above enumerated was timely filed by Plaintiff with Defendant on January 27, 1958, but no action thereon had been taken by the Commissioner of Internal Revenue within six months of the date of filing each such claim. After the expiration of said six months' period, Plaintiff thereupon on October 7, 1958, filed this suit for refund of each of the three types of taxes herein described in paragraph I.

III. The following facts are admitted, and require no proof:

(A) (1) Plaintiff at all times mentioned was and is a corporation organized and existing under the laws of Connecticut, duly qualified to do business in California, having its principal place of business and office in California in San Francisco, and a branch office in Los Angeles.

(2) Defendant is now and since November 26, 1952, has been the duly appointed, qualified and acting District Director of Internal Revenue for the Los Angeles District of California. Defendant is the person to whom [131] all of the taxes, penalty, and interest involved herein were paid under protest by Plaintiff. Defendant at all times herein mentioned was and is a resident of the County of Los Angeles and of the Southern District of California, Central Division.

(3) On October 6, 1953, White-Ahlgren Company, Inc., hereinafter referred to as "White-Ahl-

gren," entered into a subcontract with Marine Development, Inc., hereinafter referred to as "Marine Development," to do and complete all concrete work as specified for 1,000 Unit Wherry Housing Projects at Camp Pendleton, California. Work under the said subcontract commenced on or about December 7, 1953.

(4) On or about October 6, 1953, White-Ahlgren made a written Application to Plaintiff for a Contract Bond and Agreement of Indemnity in the amount of White-Ahlgren's said subcontract with Marine Development, viz., \$549,138.20.

(5) On or about December 2, 1953, a Surety Bond described as Contract Bond No. 291379, was executed in the said amount of \$549,138.20 by and on behalf of White-Ahlgren as Principal, The Century Indemnity Company, Plaintiff, as Surety, Marine Development, as Owner, and Republic National Bank of Dallas, Texas, as Mortgagee.

(6) On or about December 2, 1953, White-Ahlgren opened a Commercial checking account in the Security Trust and Savings Bank of San Diego, California, known as White-Ahlgren Trust Account No. 1. Checks drawn against said Trust Account No. 1 and signed by either Albert C. White or W. T. Ahlgren on behalf of White-Ahlgren were also to be signed by any one of several designated representatives of Plaintiff who was to sign as Trustee. On a signature card of the Security Trust and Savings Bank of San Diego, California, dated Decem-



ber 2, 1953, Plaintiff's Exhibit 4(a), Eva L. Cole and Frank D. Cole were designated as signatories for Plaintiff. On another signature card of said bank, also dated December 2, 1953, [132] Plaintiff's Exhibit 4(b), Eva L. Cole, Frank D. Cole or D. J. Waite were designated as signatories for Plaintiff. The latter said signature card was superseded by another signature card of said bank, dated April 19, 1954, Plaintiff's Exhibit 4(c), in which Eva L. Cole, Robert H. Easton and Burton A. Van Tassel were named as trustee signatories for Plaintiff. Another signature card in said bank, dated June 11, 1954, Plaintiff's Exhibit 4(d), naming Burton A. Van Tassel, D. J. Waite or Eva L. Cole as trustee signatories, was substituted for Plaintiff's Exhibit 4(c). Beginning with the weekly payroll period ended March 15, 1954, and ending with the completion of its subcontract on or about September 17, 1954, wage payments were made directly from the aforesaid Trust Account No. 1 to employees shown on White-Ahlgren's payrolls on checks signed by either Albert C. White or W. T. Ahlgren and countersigned by a representative of Plaintiff as Trustee. On or about May 28, 1954, a general account was opened by White-Ahlgren in a branch of said Security Trust and Savings Bank of San Diego, at Carlsbad, California, with funds transferred thereto from said Trust Account No. 1, to enable White-Ahlgren to make termination wage payments to its employees working on the said subcontract with Marine Development at Camp Pendleton, Cali-

fornia. The authorized signatories on said account were W. T. Ahlgren, Albert C. White, and D. J. Waite, any two of whom were authorized to sign checks on said account. When the subcontract was completed all remaining funds in the Carlsbad account were retransferred to White-Ahlgren Trust Account No. 1 in the aforesaid San Diego Bank.

(7) Weekly payrolls for the employees of White-Ahlgren were made up by the latter's bookkeeper in the following manner: A time card for each employee was prepared by the foreman for White-Ahlgren and presented to the bookkeeper for computation. A recap of the total payroll was then prepared by the latter showing each employee's name, hours worked, rate of pay, gross amount due, total tax deductions, and [133] net amount due, and a copy of said payroll recap was furnished to the representative of Plaintiff before such net amounts were paid to the individual employees.

(8) On December 2, 1953, Marine Development made a loan to White-Ahlgren representing an advance of \$10,000.00 against future progress payments under the aforesaid subcontract, and that amount was deposited on the same date in the aforesaid Trust Account No. 1 in the aforesaid San Diego Bank.

(9) Beginning with the loan against future progress payments by Marine Development to White-Ahlgren on December 2, 1953, in the amount of \$10,000.00, Marine Development paid to White-



Ahlgren Trust Account No. 1 or to White-Ahlgren Company, Inc., to and including September 3, 1954, the date of the last payment, the total sum of \$496,882.55. From the original contract price of \$549,138.20, there were deducted \$518.40, representing cost of a retaining wall deleted from the subcontract, and back charges by Marine Development against White-Ahlgren in the amount of \$1,862.35, but there were added certain extras over and above the original contract price in the amount of \$4,374.28, making a total of \$551,131.73. Deducting the aforesaid total payments by Marine Development to White-Ahlgren of \$496,882.55, left a balance of \$54,249.18, which amount was paid by Marine Development to Plaintiff on December 17, 1954. Simultaneous with the payment of \$54,249.18 to Plaintiff by Marine Development, Plaintiff executed and delivered to Marine Development an "Agreement of Release and Indemnity," Defendant's Exhibit F. Prior thereto a levy was served on December 3, 1954, on Marine Development by Defendant for unpaid Internal Revenue taxes of Wright-Ahlgren Company (i.e., White-Ahlgren Company) in the amount of \$12,718.11. Plaintiff paid to creditors of White-Ahlgren for labor and materials furnished to White-Ahlgren the approximate sum of \$119,188.17. Between November, 1954, and the present date, Plaintiff made recoveries in connection with claims asserted under the said Surety Bond in the total amount of \$70,723.64, Plaintiff's Exhibit 20. [134]



(10) Plaintiff never paid any of its own funds to White-Ahlgren for payroll purposes, with the exception of \$1,090.00, in September, 1954, paid to White-Ahlgren Trust Account No. 1 to enable White-Ahlgren to meet in full its final payroll upon completion of said subcontract.

(11) An Employer's Quarterly Federal Tax Return covering both Withholding taxes and Federal Insurance Contributions Act taxes for the fourth quarter of 1953, was filed by White-Ahlgren with Defendant on July 6, 1956, and was therefore delinquent. It was not accompanied by payment of the tax.

(12) Prior to October 6, 1953, on which date Marine Development and White-Ahlgren entered into the aforesaid subcontract for work at Camp Pendleton, California, Wright-Ahlgren Company, Inc., had made a contract with the Webb-Knapp Company at San Diego, California, providing for the installation of cement slabs, curbs, etc., in a housing project at San Diego, and work under that contract was still in progress on December 2, 1953.

(13) On August 31, 1953, the name of Wright-Ahlgren Company, Inc., a Nevada corporation, was changed to White-Ahlgren Company, Inc.

(14) On or about February 19, 1954, White-Ahlgren did pay to Defendant, by check drawn on said Trust Account No. 1 and countersigned by Eva L. Cole, Trustee, the sum of \$10,397.71, repre-

senting Federal Withholding and Employment taxes due from Wright-Ahlgren Company, Inc., for the 3rd Quarter of 1953, Defendant's Exhibit J.

(15) On August 22, 1956, Defendant made assessments against White-Ahlgren and Plaintiff jointly of combined Withholding and Federal Insurance Contributions Act taxes and delinquency penalties for the fourth quarter of 1953 and for the first, second and third quarters of 1954, as follows: [135]

Taxable Period	Amount Assessed
WT:FICA	T \$ 754.15
4Q53	P 188.54
WT:FICA	T 9,911.00
1Q54	P 2,477.75
WT:FICA	T 14,810.10
2Q54	P 3,702.53
WT:FICA	T 4,759.19
3Q54	P 1,189.80

(16) Thereafter, Defendant issued three 10-day Notices and Demands, each dated August 27, 1956, for payment for the fourth quarter of 1953, and the second and third quarters of 1954, respectively, addressed to:

“White Ahlgren Co. & Century Indemnity Co., 7405 Alvarado Freeway, La Mesa, Calif.”

in each case for “Income tax withheld from wages and FICA taxes,” as follows:

4Q53		
Assessment		Balance Due
\$ 754.15		\$ 942.69
P 188.54		Int 118.63
		<hr/>
		\$1,061.32
2Q54		
\$14,810.10		\$18,512.63
P 3,702.53		Int 1,830.68
		<hr/>
		\$20,343.31
3Q54		
\$4,759.19		\$5,948.99
P 1,189.80		Int. 516.90
		<hr/>
		\$6,465.89

Defendant also issued a 10-day Notice and Demand for payment, dated August 27, 1956, addressed as follows:

“White Ahlgren Co., Inc., c/o Walter T. Ahlgren, 7405 Alvarado Freeway, La Mesa, Calif., and Century Indemnity Co.

(Name added to assessment list per memo 9/27/56)”

for “Income tax withheld from wages and FICA taxes,” as follows:

1Q54		
Assessment		Balance Due
\$9,911.00		\$12,388.75
P 2,477.75		Int 1,375.45
		<hr/>
		\$13,764.20

Pursuant to the foregoing 10-day Notices and Demands for combined “Withholding and FICA taxes,” and after segregating the amounts for with-



holding taxes alone, Plaintiff, under protest, paid to Defendant on November 12, 1957, the following withholding taxes, one delinquency penalty, the other delinquency penalties having been abated by Defendant, and interest to November 12, 1957:

Period	Tax	Delinquency Penalty	Interest
4th Quarter, 1953.....	\$ 649.22	\$162.31	\$ 159.33
1st Quarter, 1954.....	6,977.35	-----	1,479.00
2nd Quarter, 1954 .....	10,662.98	-----	2,100.31
3rd Quarter, 1954 .....	3,403.85	-----	619.41

(17) Pursuant to the provisions of Section 322(b)(1) of the 1939 Internal Revenue Code and/or Section 6511(a) of the 1954 Internal Revenue Code, Plaintiff filed with Defendant, within the period allowed by law, a timely and proper claim for refund of said tax, penalty, and interest in the amount of \$26,213.76 assessed by Defendant and paid by Plaintiff as aforesaid. A true copy of said claim for refund was attached to Plaintiff's Complaint herein marked Exhibit "D." Defendant denies that assessment and collection of taxes from Plaintiff was in any manner illegal, and further denies the validity of each and every ground upon which Plaintiff's claim for refund is based, and except as herein otherwise specifically admitted, denies the truth of each and every allegation contained therein.

(18) Pursuant to the foregoing 10-Day Notices and Demands for combined "Withholding and FICA taxes," and after segregating the amounts

for Federal Insurance Contributions Act taxes alone, Plaintiff, under protest, paid to Defendant on November 12, 1957, the following FICA taxes, one delinquency penalty, the other delinquency penalties having been eliminated by Defendant, and interest to November 12, 1957: [137]

Period	Tax	Delinquency Penalty	Interest
4th Quarter, 1953.....	\$ 104.93	\$26.23	\$ 25.75
1st Quarter, 1954.....	2,933.65	.....	621.85
2nd Quarter, 1954.....	4,147.12	.....	816.87
3rd Quarter, 1954.....	1,355.34	.....	246.63

(19) Pursuant to the provisions of Section 322(b)(1) of the 1939 Internal Revenue Code and/or Section 6511(a) of the 1954 Internal Revenue Code, Plaintiff filed with Defendant, within the period allowed by law, a timely and proper claim for refund of said tax, penalty, and interest in the amount of \$10,278.37 assessed by Defendant and paid by Plaintiff as aforesaid. A true copy of said claim for refund was attached to Plaintiff's Complaint herein marked Exhibit "E." Defendant denies that assessment and collection of taxes from Plaintiff was in any manner illegal, and further denies the validity of each and every ground upon which Plaintiff's claim for refund is based, and except as herein otherwise specifically admitted, denies the truth of each and every allegation contained therein.

(20) On August 22, 1956, Defendant made assessments against White-Ahlgren and Plaintiff

jointly of Federal Unemployment Tax Act taxes for the year 1954, in the amount of \$3,524.84, and delinquency penalty of \$881.21.

(21) Thereafter, on August 27, 1956, Defendant issued a 10-Day Notice and Demand for payment of said Federal Unemployment Tax Act taxes for the year 1954 of \$3,524.84, together with delinquency penalty of \$881.21, and interest of \$329.96, a total of \$4,736.01, addressed as follows:

“White Ahlgren Co., Inc., c/o Walter T. Ahlgren, 7405 Alvarado Freeway, La Mesa, Calif., and Century Indemnity Co.

(Name added to assessment list per memo 9/27/56)”

(22) Pursuant to the aforesaid 10-Day Notice and Demand for payment of said Federal Unemployment Tax Act taxes, delinquency penalty and interest for the year 1954, Plaintiff, under protest, paid to [138] Defendant on November 12, 1957, the amount of \$4,113.39, made up of tax of \$3,524.84 and interest to date of payment of \$588.55. In the meantime the penalty had been abated by Defendant.

(23) Pursuant to the provisions of Section 322(b)(1) of the 1939 Internal Revenue Code and/or Section 6511(a) of the 1954 Internal Revenue Code, Plaintiff filed with Defendant, within the period allowed by law, a timely and proper claim for refund of said tax and interest in the amount



of \$4,113.39 assessed by Defendant and paid by Plaintiff as aforesaid. A true copy of said claim for refund was attached to Plaintiff's Complaint herein marked Exhibit "F." Defendant denies that assessment and collection of taxes from Plaintiff was in any manner illegal, and further denies the validity of each and every ground upon which Plaintiff's claim for refund is based, and except as herein otherwise specifically admitted, denies the truth of each and every allegation contained therein.

(24) No action has been taken by Defendant, by the Commissioner of Internal Revenue, or by the Secretary of the Treasury or his delegate, with respect to any of the three aforesaid Claims for Refund of Withholding taxes, Federal Insurance Contributions Act taxes, or Federal Unemployment Act taxes, respectively, and no part of any of the said taxes, delinquency penalty, or interest has been refunded or credited to Plaintiff. More than six months' time had expired from the respective dates of filing said three Claims for Refund before the date of filing of the Complaint herein in this Court.

IV. None.

V. None.

VI. The only issue of fact remaining to be litigated upon the Trial is whether or not, for purposes of the Withholding, Federal Insurance Contributions Act taxes, and Federal Unemployment Act taxes, Plaintiff was the employer of the employees of White-Ahlgren during the periods involved

herein. Plaintiff contends that this is a mixed question of fact and law.

VII. The Exhibits to be offered at the Trial, together with a [139] statement of all admissions by and issues between the parties with respect thereto, are as follows:

(A) Plaintiff's Exhibits—

(1) Exhibit 1—Copy of subcontract between Marine Development, Inc., and White-Ahlgren Company, Inc., dated October 6, 1953.

(2) Exhibit 2—Copy of Application by White-Ahlgren Company, Inc., to Plaintiff for Contract Bond and Agreement of Indemnity, dated October 6, 1953.

(3) Exhibit 3—Copy of Contract Bond No. 291379 between White-Ahlgren Company, Inc., as Principal, and Plaintiff as Surety, executed December 2, 1953.

(4) Exhibit 4—Copy of four Signature Cards of the Security Trust & Savings Bank of San Diego, California, authorizing withdrawals of funds from White-Ahlgren Trust Account No. 1 in said Bank.

- (a) Signature Card A dated 12/2/53.
- (b) Signature Card B dated 12/2/53.
- (c) Signature Card C dated 4/19/54.
- (d) Signature Card D dated June 11, 1954.

(5) Exhibit 5—Copy of Signature Card of the Security Trust & Savings Bank of San Diego, Cali-

fornia, authorizing withdrawals of funds from the White-Ahlgren Company, Inc., Account in said Bank.

(6) Exhibit 6—Copy of 30 voucher checks of Marine Development, Inc., payable to the order of White-Ahlgren Trust Account No. 1, and/or White-Ahlgren Company, Inc., aggregating \$496,882.55.

(7) Exhibit 7—Copy of Resolution of Board of Directors of White-Ahlgren Company, Inc., dated December 8, 1953, signed by Irene Higgins, Secretary for White-Ahlgren Company, Inc.

(8) Exhibit 8—Copy of Schedule of Progress payments by Marine Development, Inc., to White-Ahlgren Company, Inc., from December 2, 1953, to December 17, 1954, including final retention payments to Plaintiff. [140]

(9) Exhibit 9—Recapitulation showing amount of subcontract, dated October 6, 1953, between Marine Development, Inc., and White-Ahlgren Company, Inc., with decrease and increases in contract price, amount paid to White-Ahlgren Company, Inc., and retention payment by Marine Development to Plaintiff.

(10) Exhibit 10—Copy of letter of March 23, 1954, from Robert A. Oakes of Oakes & Horton, Bank of America Building, San Diego 1, California, Attorneys for Marine Development, Inc., addressed to Miss Eva L. Cole, Los Angeles, California, modi-



fying the subcontract of October 6, 1953, Plaintiff's Exhibit 1.

(11) Exhibit 11—Copy of Certificate by Secretary of State of Nevada, dated May 14, 1957, of Amendment of Articles of Incorporation of Wright-Ahlgren Company, Inc., changing name to White-Ahlgren Company, Inc., as of August 31, 1953.

(12) Exhibit 12—Copy of three Ten-Day Notices and Demands, issued by Defendant, each dated August 27, 1956, for payment of "Income tax withheld from wages and FICA taxes," and addressed to:

"White-Ahlgren Co., Inc. & The Century Indemnity Co., 7405 Alvarado Freeway, La Mesa, Calif."

(13) Exhibit 13—Copy of Ten-day Notice and Demand issued by Defendant, dated August 27, 1956, for payment of "Income tax withheld from wages and FICA taxes," for the 1st Quarter of 1954, addressed to:

"White-Ahlgren Co. c/o W. T. Ahlgren, 7405 Alvarado Freeway, La Mesa, Calif., and Century Indemnity Co., Special Procedure.

(Name added to assessment list per memo. 9/27/59)."

(14) Exhibit 14—Copy of Ten-Day Notice and Demand issued by Defendant, dated August 27, 1956, for payment of FUTA tax, for the year 1954, addressed to:

“White-Ahlgren Co. c/o Walter T. Ahlgren, 7405 Alvarado Freeway, La Mesa, Calif., and Century Indemnity Co., Special Procedure.

(Name added to assessment list per memo. 9/27/56)” [141]

(15) Exhibit 15—Copy of letter dated November 12, 1957, from office of District Director of Internal Revenue at Los Angeles, addressed to Arthur H. Deibert, Counsel for Plaintiff.

(16) Exhibit 16—Copy of letter dated November 21, 1957, from office of District Director of Internal Revenue at Los Angeles, addressed to Arthur H. Deibert, Counsel for Plaintiff.

(17) Exhibit 17—Copy of Claim for Refund of Withholding taxes filed by Plaintiff with Defendant on or about January 27, 1958, which taxes were paid by Plaintiff to Defendant on November 12, 1957.

(18) Exhibit 18—Copy of Claim for Refund of Federal Insurance Contributions Act taxes filed by Plaintiff with Defendant on or about January 27, 1958, which taxes were paid by Plaintiff to Defendant on November 12, 1957.

(19) Exhibit 19—Copy of Claim for Refund of Federal Unemployment Tax filed by Plaintiff with Defendant on January 27, 1958, which tax was paid to Defendant on November 12, 1957.

(20) Exhibit 20—Copy of Schedule of bills of White-Ahlgren Company, Inc., for materials, etc., paid by Plaintiff in the total amount of \$119,118.17.

(21) Exhibit 21—Copy of Affidavit of George T. Holbrook, Secretary of Plaintiff, showing recoveries received by Plaintiff to date thereof, in the amount of \$64,223.64.

(22) Exhibit 22—Report on Payroll Tax Liabilities of White-Ahlgren Company, Inc., for 4th Quarter of 1953, and 1st, 2nd and 3rd Quarters of 1954, by Charles I. Corp, Certified Public Accountant.

(23) Exhibit 23—Stipulation as to Facts, pp. 14 to 20, inclusive, and Exhibit "C," pp. 22 and 23 of Transcript of Record in Fireman's Fund Indemnity Company, Appellant, v. United States of America, Appellee, United States Court of Appeals for the Ninth Circuit, No. 13341.

(24) Exhibit 24—Subordination Agreement, dated December 2, 1953, between White-Ahlgren Company, Inc., Contractor, Heartha A. Clausen, Creditor, and Plaintiff, Surety. [142]

(25) Exhibit 25—Letter dated January 15, 1954, from Eva L. Cole, Trustee for Plaintiff, to Security-First National Bank of San Diego, Attention Mr. Frazier, Vice President.

(26) Exhibit 26—Copy of draft dated 11/12/57 by Burton A. Van Tassel, Attorney for Plaintiff, payable to Internal Revenue Service in the amount of \$40,607.02 in payment of taxes involved herein.

(B) Defendant's Exhibits are as follows:



(1) Exhibit A—Copy of letter dated November 16, 1953, from D. J. Waite, Attorney in Fact for Century Indemnity Company to Marine Development, Inc.

(2) Exhibit B—Copy of Instruction to Security Trust and Savings Bank of San Diego re White-Ahlgren Trust Account No. 1, dated December 2, 1953, and bearing the signatures of W. T. Ahlgren, Eva L. Cole, D. J. Waite, Frank D. Cole, Irene Higgins and M. Frazier.

(3) Exhibit C—Copy of Power of Attorney appointing Eva L. Cole and others as Attorneys in Fact for Century Indemnity Company executed by J. G. Hasselbrack on March 11, 1952, on behalf of Century Indemnity Company.

(4) Exhibit D—Copies of account ledgers of Security Trust and Savings Bank of San Diego re White-Ahlgren Trust Account No. 1 for the period December 7, 1953, through December 6, 1954.

(5) Exhibit E—Copies of account ledgers of Security Trust and Savings Bank of San Diego re White-Ahlgren Company, Inc., account for the period December 10, 1953, through August 24, 1956.

(6) Exhibit F—Copy of Agreement of Release and Indemnity, dated December 17, 1954, and signed by Burton A. Van Tassel, Attorney in Fact, on behalf of Century Indemnity Company.

(7) Exhibit G—Copy of letter dated July 2, 1954, from Burton A. Van Tassel on behalf of Century Indemnity Company to Marine Development, Inc.

(8) Exhibit H—Copy of check No. 2468 dated December 17, 1954, drawn on the Republic National Bank of Dallas, Texas, by Marine [143] Development, Inc., and made payable to the order of Century Indemnity Company in the amount of \$54,249.18.

(9) Exhibit I—Deposition of Martin E. Frazier taken at San Diego, California, on July 14, 1959.

(10) Exhibit J—Copy of check No. 2469507 dated February 17, 1954, drawn on White-Ahlgren Trust Account No. 1, signed by Albert C. White and countersigned by Eva L. Cole, Trustee, and made payable to Director of Internal Revenue in the amount of \$10,397.71.

Plaintiff admits the authenticity and due execution of each of Defendant's exhibits (except as hereinafter otherwise set forth) but reserves the right to object to the introduction of any of said exhibits on the grounds of irrelevancy, immateriality, and/or incompetency.

Defendant admits the authenticity and due execution of each of Plaintiff's exhibits (except as hereinafter set forth) but reserves the right to object to the introduction of any of said exhibits on the grounds of irrelevancy, immateriality, and/or incompetency. Defendant does not admit the authenticity and due execution of Plaintiff's Exhibits 7, 9, 22, and 23, and reserves the right to object to said exhibits on said grounds in addition to the grounds hereinabove set forth.

VIII. Plaintiff contends that the only issue of law remaining to be litigated upon the Trial is as stated in paragraph VI herein, and that such issue is a mixed question of fact and law. Defendant contends that the issue of fact hereinbefore set forth in paragraph VI is the only issue remaining to be litigated in this case and that there are no issues of law remaining to be litigated herein.

IX. The foregoing Admissions have been made by the parties, and the parties having specified the foregoing issue remaining to be litigated, this order shall supplement the pleadings and govern the trial of this cause, unless modified to prevent manifest injustice. Nothing [144] contained herein shall be deemed to preclude the parties from filing a supplemental order in order to shorten the time of trial.

Dated: October 5, 1959.

/s/ PEIRSON M. HALL,  
United States District Judge.

Approved as to form and content.

/s/ ARTHUR H. DEIBERT,  
/s/ BURTON A. VAN TASSEL,  
Attorneys for Plaintiff.

/s/ EUGENE N. SHERMAN,  
Attorney for Defendant.

[Endorsed]: Filed October 5, 1959. [145]



[Title of District Court and Cause.]

AMENDED AND SUPPLEMENTAL  
PRE-TRIAL CONFERENCE ORDER

Following pre-trial proceedings pursuant to Rule 16 of the Federal Rules of Civil Procedure and Local Rule 9 of this Court, on October 5, 1959, when the proposed original Pre-Trial Conference Order was filed, and an adjournment of said hearing to November 30, 1959, at which time this case was set for trial at 10:00 a.m., February 8, 1960, and subsequently continued to September 13, 1960, It Is Further Ordered: [158]

That, unless otherwise herein provided, the terms and conditions of said original Pre-Trial Conference Order shall apply likewise to this Amended and Supplemental Pre-Trial Conference Order.

That there shall be added by way of amendment and supplement under Paragraph III-A, as facts which are admitted and require no proof, the following:

(25) Paragraph III-A(7), page 4, is amended and supplemented at line 32 by inserting after "rate of pay" the following: "(where the employee worked at an hourly rate of pay)."

(26) Paragraph III-A(9), lines 9 through 13 are amended and supplemented to read as follows:

(9) Beginning with the loan against future progress payments by Marine Development to

White-Ahlgren on December 2, 1953, in the amount of \$10,000.00, Marine Development paid, by checks made payable to White-Ahlgren Trust Account No. 1 or to White-Ahlgren Company, Inc., to and including September 3, 1954, the date of the last payment, the total sum of \$496,882.55. All of said checks were deposited directly into the White-Ahlgren Trust Account No. 1.

(27) The last sentence of Paragraph III-A(9), lines 29 through 32, page 5, is amended to read as follows:

Plaintiff made recoveries in connection with claims asserted under the said Surety Bond in the total amount of \$70,723.64.

(28) Paragraph III-A(12) is amended and supplemented as follows:

Prior to October 6, 1953, on which date Marine Development and White-Ahlgren entered into the aforesaid subcontract for work at Camp Pendleton, California, Wright-Ahlgren Company, Inc. (which was renamed White-Ahlgren Company, Inc., on [159] August 31, 1953) had made a contract with Crevette Construction Company, a subsidiary of Webb-Knapp Company, at San Diego, California, providing for the installation of cement slabs, curbs, etc., in housing projects at San Diego, California, and work under that contract was still in progress on December 2, 1953. On May

28, 1954, White-Ahlgren assigned to plaintiff all of its rights under said contract with the Crevette Construction Company, and all of its right, title and interest in and to certain mechanic liens recorded in connection with its performance of labor and furnishing of materials thereunder. Plaintiff's Exhibit 27 is a copy of said assignment. Pursuant to said assignment, Plaintiff was paid the sum of \$5,514.38 in November, 1954, by the Webb-Knapp Company in full discharge of the rights and mechanic liens of Wright-Ahlgren under said contract.

(29) Employer's Quarterly Federal Tax Returns covering both Withholding taxes and Federal Insurance Contributions Act taxes for the first, second and third quarters of 1954, were timely filed with Defendant by White-Ahlgren under its former name, Wright-Ahlgren Company, Inc., but were not accompanied by payment of the tax. Thereafter an amended Employer's Quarterly Federal Tax Return for the first quarter of 1954 was filed with Defendant under the name "White-Ahlgren Co.," and amended returns for the second and third quarters of 1954 were filed under the name "White-Ahlgren Co. and Century Indemnity Co." The latter two returns were executed and filed by Defendant pursuant to Section 6020(b) of the Internal Revenue Code of 1954, as amended. The amended returns were not accompanied by payment of tax. The tax assessments made against Plaintiff



herein were based upon the taxes shown to be due on said amended returns. [160]

(30) An Annual Federal Tax Return of Employers under the Federal Unemployment Tax Act for the calendar year 1954 was timely filed with Defendant by White-Ahlgren under its former name, Wright-Ahlgren Company, Inc., but was not accompanied by payment of the tax. Thereafter an amended Annual Federal Tax Return of Employers under the Federal Unemployment Tax Act for the calendar year 1954 was filed under the name of "White-Ahlgren Company" but was not accompanied by payment of tax. The assessment made against Plaintiff herein on account of said tax was based on the tax shown to be due on said amended return.

That there shall be added under Paragraph VII(A), beginning on page 10 of the original Pre-Trial Conference Order, the following Plaintiff's Exhibits:

(31) Exhibit 27—Copy of Assignment dated May 28, 1954, from Wright-Ahlgren Company to The Century Indemnity Company of all debts, accounts, claims, etc., against Crevette Construction Company, a subsidiary of Webb-Knapp Company, as well as certain mechanics' liens recorded in San Diego County.

(32) Exhibit 28—Copy of letter dated October 7, 1954, from Robert A. Oakes to Burton A. Van Tassel.

(33) Exhibit 29—Deposition of Robert A. Oakes, taken at La Jolla, California, on July 14, 1959.

(34) Exhibit 30—Deposition of Harry L. Summers, taken at La Jolla, California, on July 14, 1959.

(35) Exhibit 31—Deposition of Charles E. Sands, taken at La Jolla, California, on July 14, 1959.

There shall be added under Paragraph VII(B), beginning on page 14 of the original Pre-Trial Conference Order, the following Defendant's Exhibits:

(11) Exhibit K—Annual Federal Tax Return of Employers (Form 940) for the calendar year 1954 of Wright-Ahlgren Co., Inc., filed November 1, 1954. [161]

(12) Exhibit L—Annual Federal Tax Return of Employers (Form 940) for the calendar year 1954 of White-Ahlgren Co., filed August 21, 1956.

(13) Exhibit M—Employer's Quarterly Federal Tax Return (Form 941) of Wright-Ahlgren Company, Inc., for the fourth quarter of 1953, filed August 16, 1956.

(14) Exhibit N—Employer's Quarterly Federal Tax Return (Form 941) of White-Ahlgren Co. for the fourth quarter of 1953, filed August 16, 1956.

(15) Exhibit O—Employer's Quarterly Federal Tax Return (Form 941) of Wright-Ahlgren Co., Inc., for the first quarter of 1954, filed April 30, 1954.

(16) Exhibit P—Employer's Quarterly Federal Tax Return (Form 941) of White-Ahlgren Co. for the first quarter of 1954, filed August 21, 1956.

(17) Exhibit Q—Employer's Quarterly Federal Tax Return (Form 941) of Wright-Ahlgren Company, Inc., for the second quarter, 1954, filed August 2, 1954.

(18) Exhibit R—Employer's Quarterly Federal Tax Return (Form 941) for White-Ahlgren Co. and Century Indemnity Co. for the second quarter of 1954, filed August 21, 1956.

(19) Exhibit S—Employer's Quarterly Federal Tax Return (Form 941) of Wright-Ahlgren Company, Inc., for the third quarter of 1954, filed November 1, 1954.

(20) Exhibit T—Employer's Quarterly Federal Tax Return (Form 941) for White-Ahlgren Company, Inc., and The Century Indemnity Co. for the third quarter of 1954, filed August 21, 1956. [162]

The paragraph beginning on line 10, page 15, is amended and supplemented to read as follows:



Plaintiff admits the authenticity and due execution of each of Defendant's Exhibits (except as hereinafter otherwise set forth), but reserves the right to object to the introduction of any of said Exhibits on the grounds of irrelevancy, immateriality, and/or incompetency; except that Plaintiff waives any objection to the introduction of Defendant's Exhibit I on the grounds of competency and/or hearsay, reserving, however, each and all objections specifically reserved and/or made at the time of the taking of said deposition as reflected in the Reporter's Transcript thereof.

The paragraph beginning on line 14, page 15, is amended and supplemented to read as follows:

Defendant admits the authenticity and due execution of each of Plaintiff's Exhibits (except as hereinafter set forth), but reserves the right to object to the introduction of any of said Exhibits on the grounds of irrelevancy, immateriality and/or incompetency; except that Defendant waives any objection to the introduction of Plaintiff's Exhibits 29, 30, and 31 on the grounds of competency, and/or hearsay, reserving, however, each and all objections specifically reserved and/or made at the time of the taking of said three depositions as reflected in the Reporter's Transcript thereof. Defendant does not admit the authenticity and due execution of Plaintiff's Exhibits 7, 9, 22 and 23, and reserves the right to object to said [163] Ex-

hibits on said grounds in addition to the grounds hereinabove set forth.

Nothing contained herein shall be deemed to preclude the parties from filing a further Supplemental Order for the purpose of shortening the time of trial.

Dated: September 13th, 1960.

/s/ PEIRSON M. HALL,  
United States District Judge.

Approved as to form and content.

/s/ ARTHUR H. DEIBERT,  
/s/ BURTON A. VAN TASSEL,  
/s/ A. L. BURFORD, JR.,  
Attorneys for Plaintiff.

LAUGHLIN E. WATERS,  
United States Attorney;

EDWARD R. McHALE,  
Asst. U. S. Attorney,  
Chief, Tax Division;

EUGENE N. SHERMAN,  
Asst. U. S. Attorney,

/s/ EUGENE N. SHERMAN,  
Attorneys for Defendant,  
Robert A. Riddell.

[Endorsed]: Filed September 13, 1960. [164]

[Title of District Court and Cause.]

DEFENDANT'S OBJECTIONS TO PLAINTIFF'S PROPOSED FINDINGS OF FACT, CONCLUSIONS OF LAW AND JUDGMENT

\* \* \*

II.

Objection is made to the manner in which paragraph VI of plaintiff's proposed findings describes the circumstances under which the joint control account known as the "White-Ahlgren Trust Account No. 1" was opened. As presently proposed, this finding omits any reference to the important fact that this joint control account was required by plaintiff as a condition precedent to its issuance of the subject indemnity bond.

Both the documentary and oral evidence in this case is beyond rational dispute on this point. Thus, defendant's Exhibit "A," a letter from D. J. Waite, plaintiff's bonding manager, to Marine Development, Inc., under date of November 16, 1953 (i.e., before the bond was issued), states as follows:

"We as surety do commit ourselves to a firm agreement that upon receipt of \$25,000.00 in cash by White-Ahlgren Company, Inc., which is anticipated to be put into the corporation on or before November 25, 1953, and an advance payment of \$10,000.00 by Marine Development, Inc., to White-Ahlgren Company, Inc., which specific



sum of money is to be deposited in a special bank account of White-Ahlgren Company, Inc., of which we as surety will have joint control, we agree that when said conditions have been met that we will issue to you a bond guaranteeing the performance and payment of labor and material bills in the amount of 100% of the contract price.” (Underscoring Ours.)

This requirement was consummated in the instructions issued to the Security Trust and Savings Bank of San Diego with reference to the joint control account, defendant’s Exhibit “B.” Said exhibit, which was signed by the representatives of plaintiff and the White-Ahlgren [173] Company, specifically declares that:

“The title to said account, and any balance that may be therein at any time is hereby vested and declared to be held by the aforesaid Trustee and Attorneys in Fact of the Century Indemnity Company, as security to the Century Indemnity Company that all funds to the credit of said account at any time shall be used solely for the purpose of paying bills for labor and material and all obligations entering into a certain construction project with reference to the completion of which said The Century Indemnity Company has executed an Indemnity Bond.”

Similarly, all designated trustees over the account were acting on behalf of plaintiff (Par. III (A)(6)

on pages 3 and 4 of Pretrial Conference Order, filed October 5, 1959).

The deposition testimony of Harry L. Summers, Vice President of Marine Development, Inc., (Plaintiff's Exhibit "30"), is explicit on the point that it was his understanding from plaintiff's representative that plaintiff required the opening of the joint control account as a condition precedent to its issuance of the bond (Plaintiff's Exhibit "30," page 15, line 14, to page 16, line 19). This understanding was confirmed by the testimony of D. J. Waite, who stated that the parties concerned were advised by him that plaintiff would require a joint control account before the bond would be written. (Reporter's Partial Transcript of Proceedings, page 53, lines 2-5.)

While plaintiff concedes that it exercised joint control over the subject bank account, it would now have us believe, by virtue of the testimony of Eva L. Cole, that such control was not required by plaintiff but was really a means by which the [174] investment of Mrs. Hertha Claussen was to be protected. No evidence corroborating this theory was offered at the trial, and Mrs. Cole admitted upon cross-examination that she neither regularly consulted with or accounted to Mrs. Claussen for her conduct as trustee (Reporter's Transcript, page 21, line 5, to page 23, line 9); and that in all respects, including her activities with reference to the joint control account, Mrs. Cole was acting as an agent for the

Century Indemnity Company (Reporter's Transcript, page 28, line 24, to page 25, line 4).

In any event, the testimony of D. J. Waite is clear that, regardless of who originally conceived the idea of imposing a joint control requirement, said idea was adopted by Waite, on behalf of plaintiff, before plaintiff would issue its bond (Reporter's Transcript, page 52, line 25, to page 53, line 1), and it has been shown above that the parties concerned were so advised before the bond was written.

The clarity of the evidence on this point of objection is best demonstrated by the following excerpt from the transcript of testimony of Albert C. White (who testified after Eva L. Cole and D. J. Waite).

“Q. And was it your understanding at that time from your conversation with Mrs. Cole that as per the letter the bonding company would require the joint control account?

“Mr. Burford: If the court please, I assume that this is supposed to be cross-examination, none of this being covered on direct.

“The Court: I suppose. I don't know what difference it makes with this witness.

“Mr. Sherman: Your Honor, I think we have the witness here and it is proper cross-examination.

“The Court: Is there any doubt but what The Century [175] Indemnity Company wanted joint control of this account?

“Mr. Sherman: Mrs. Cole testified she has never seen that letter.



“The Court: I mean on the part of the plaintiff here. Is there any question but what Century Indemnity wanted to and did have joint control of this account?”

“Mr. Burford: We have stipulated that there was joint control.

“The Court: Then why cross-examine him on it?”

“Mr. Sherman: Very well, your Honor.”

(Reporter's Transcript, page 59, line 12, to page 60, line 8.)

The record shows that pursuant thereto no further examination of the witness was made on this matter.

It is submitted that the overwhelming evidence on this issue, the Court's foregoing statement of its views, the remarks of plaintiff's counsel, and defense counsel's forbearance of further cross-examination in reliance thereon, entitles the defendant to a finding that joint control of the trust account was a requirement of plaintiff. Such a finding is incorporated in paragraph VI of defendant's proposed Findings of Fact as follows:

“As a condition precedent to the issuance of said bond, plaintiff required the opening of a special bank account by White-Ahlgren Company, Inc., over which plaintiff, as surety, would have joint control. Pursuant thereto, a commercial checking account was opened in the Security Trust & Savings Bank of San Diego, California, on or about December 2, 1953, which said account was known as ‘White-Ahlgren Trust Account No. ’ ” [176]

Respectfully submitted,

LAUGHLIN E. WATERS,  
United States Attorney;

EDWARD R. McHALE,  
Assistant U. S. Attorney,  
Chief, Tax Division;

EUGENE N. SHERMAN,  
Assistant U. S. Attorney,

/s/ EUGENE N. SHERMAN,  
Attorneys for Defendant,  
Robert A. Riddell.

[Endorsed]: Filed November 10, 1960. [177]

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[Title of District Court and Cause.]

### CERTIFICATE OF PROBABLE CAUSE

It appearing to the satisfaction of the Court that the subject matter of the judgment rendered in favor of the plaintiff and against the defendant in the above-entitled action is money exacted by or paid to the defendant and by him paid into the Treasury of the United States,

The Court hereby certifies that there was probable cause for the acts of the defendant in collecting said money and paying the same into the Treasury and that said defendant acted under the directions of the Secretary of the Treasury or other proper officer of the Government in so doing. U. S. Code, Title 28, Section 2006.

Dated: December 5th, 1960.

/s/ PEIRSON M. HALL,  
United States District Judge.

Certificate of Service by Mail attached.

Lodged November 10, 1960.

[Endorsed]: Filed December 5, 1960. [209]

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In the District Court of the United States in and for  
the Southern District of California, Central Di-  
vision

No. 959-58-PH Civil

THE CENTURY INDEMNITY COMPANY, a  
Corporation,

Plaintiff,

vs.

ROBERT A. RIDDELL, District Director of In-  
ternal Revenue for the Los Angeles District of  
California,

Defendant.

FINDINGS OF FACT, CONCLUSIONS OF  
LAW AND JUDGMENT

The above-entitled cause came on for trial on Sep-  
tember 20, 1960, before the Honorable Peirson M.  
Hall, Chief Judge presiding, without intervention  
of a jury, and plaintiff was represented by its coun-  
sel, Dempsey, Thayer, Deibert & Kumler and Burton  
A. Van Tassel, Arthur H. Deibert and A. L. Bur-



ford, Jr., of counsel appearing, and the defendant was represented by its counsel, Laughlin E. Waters, United States Attorney, Edward R. [211] McHale, Assistant United States Attorney, Chief, Tax Division, and Eugene N. Sherman, Assistant United States Attorney, Eugene N. Sherman, of counsel appearing.

The Court having heard and considered all the evidence, stipulations of facts, exhibits, memoranda and arguments of counsel, makes the following special findings of fact and conclusions of law.

### Findings of Fact

#### I.

At all times pertinent hereto, plaintiff was and is a corporation organized and existing under the laws of the State of Connecticut and duly qualified to do business in the State of California.

#### II.

Defendant is now and since November 26, 1952, has been the duly appointed qualified and acting District Director of Internal Revenue for the Los Angeles District of California, and is the person to whom all of the taxes, penalty and interest involved herein were paid. At all times pertinent herein, defendant was and is a resident of the County of Los Angeles and the Southern District of California, Central Division.

#### III.

The instant action was brought by plaintiff against

defendant for refund of Withholding taxes, delinquency penalty and interest, and Federal Insurance Contributions Act taxes, delinquency penalty and interest for the period commencing the fourth quarter 1953 through and including the third quarter 1954, and Federal Unemployment Act taxes and interest for the year 1954, all of which said taxes, delinquency penalty and interest were paid by the plaintiff.

#### IV.

Plaintiff duly filed timely claims for refund of the taxes, delinquency penalty and interest so paid, and the instant action was timely commenced.

#### V.

On or about October 6, 1953, White-Ahlgren Company, Inc., entered into a subcontract with Marine Development, Inc., to do and complete all concrete work as specified for a 1,000 unit Wherry Housing Project at Camp Pendleton, California. In connection therewith, a surety bond described as [212] contract bond No. 291379 was executed on or about December 2, 1953, in the amount of \$549,138.20 by and on behalf of White-Ahlgren Company, Inc., as principal, plaintiff as surety, Marine Development, Inc., as owner, and Republic National Bank of Dallas, Texas, as mortgagee. By said surety bond plaintiff guaranteed to the owner and mortgagee the faithful performance of the aforesaid subcontract and the payment of all labor and material incurred in connection with such performance. Work

under said subcontract commenced on or about December 7, 1953.

## VI.

White-Ahlgren Company, Inc., opened a commercial checking account in the Security Trust and Savings Bank of San Diego, California, on December 2, 1953, which said account was known as "White-Ahlgren Trust Account No. 1," over which White-Ahlgren Company, Inc., and plaintiff, as surety, would have joint control. The resolutions and signature cards filed with the aforesaid bank required all checks drawn against said Trust Account No. 1 by an authorized signatory of White-Ahlgren Company, Inc., to be countersigned by any one of several designated representatives of plaintiff who was to sign as trustee.

## VII.

Except for retention payments in the sum of \$54,249.18 paid directly by Marine Development, Inc., to plaintiff on December 17, 1954, all progress payments made by Marine Development, Inc., under the aforesaid subcontract were required to be and were deposited directly into said Trust Account No. 1.

## VIII.

At no time pertinent herein did plaintiff have control over the employees of White-Ahlgren Company, Inc., with reference to the hiring and discharge of said employees, the work to be performed by said employees, the hours during which said employees



were to perform their work, and the rate of pay to be received by said employees for their services.

### IX.

Plaintiff did not have control of the payment of the wages of the employees of White-Ahlgren Company, Inc., for the services rendered [213] by said employees between December 7, 1953, and March 8, 1954, during which period a weekly check made payable to White-Ahlgren Company, Inc., drawn on the aforesaid Trust Account No. 1, was signed by an authorized signatory of White-Ahlgren Company, Inc., and countersigned by a duly authorized representative of plaintiff as trustee, as follows:

A check in the gross amount due of each weekly payroll between December 7, 1953, and January 11, 1954, and a check in the net amount due (as said term is defined in paragraph X, herein) of each weekly payroll between January 12, 1954, and March 8, 1954. .

### X.

Commencing March 9, 1954, and ending with the completion of the aforesaid subcontract on September 17, 1954, wage payments were made weekly to the employees of White-Ahlgren Company, Inc., directly from the aforesaid Trust Account No. 1. Said wage payments were made by means of individual checks drawn against said Trust Account No. 1, which were made payable to the order of each individual employee in the net amount due, said "net amount due" being the weekly gross

amount of wages due, less Federal Withholding and Federal Insurance Contributions Act taxes and state taxes. Each of said checks was signed by an authorized signatory of White-Ahlgren Company, Inc., and was countersigned by a duly authorized representative of plaintiff who countersigned as trustee. The only job being performed by White-Ahlgren Company, Inc., during the periods set forth in this paragraph was the aforesaid subcontract with Marine Development, Inc., and at no time during said period did White-Ahlgren Company, Inc., receive any funds from any other job, contract or subcontract.

## XI.

Plaintiff had control of the payment of the wages of the employees of White-Ahlgren Company, Inc., for the services rendered by said employees between March 9, 1954, and September 17, 1954.

## XII.

All conclusions of law which are or are deemed to be findings of fact [214] are hereby found as facts and are incorporated herein as findings of fact.

### Conclusions of Law

#### I.

This Court has jurisdiction of the subject matter and over the parties hereto.

#### II.

At all times pertinent herein, plaintiff was not the "employer" of the employees of White-Ahlgren

Company, Inc., within the meaning of §§ 1401, 1410, and 1426(d) of the 1939 Internal Revenue Code, as amended.

### III.

Plaintiff is not liable to the defendant for the payment of the Federal Insurance Contributions Act taxes required to be collected and paid by said §§ 1401 and 1410 and is entitled to judgment against the defendant for refund of the taxes, delinquency penalty and interest so paid in the amount of \$10,-278.37, plus interest as provided by law.

### IV.

At all times pertinent herein, plaintiff was not the "employer" of the employees of White-Ahlgren Company, Inc., within the meaning of §§ 1600 and 1607(i) of the Internal Revenue Code of 1939, as amended.

### V.

Plaintiff is not liable to defendant for the payment of the Federal Unemployment Act taxes required to be paid by said § 1600 and is entitled to judgment against defendant for refund of the taxes and interest so paid in the amount of \$4,113.39, plus interest as provided by law.

### VI.

Plaintiff was not the "employer" of the employees of White-Ahlgren Company, Inc., for the period between December 7, 1953, and March 8, 1954, within the meaning of §§ 1621(d), 1622(a) and 1623 of the Internal Revenue Code of 1939, as amended.



## VII.

Plaintiff is not liable to defendant for the payment of the Withholding taxes for the period between December 7, 1953, and March 8, 1954, required [215] to be deducted, withheld and paid by said §§ 1622(a) and 1623 and is entitled to judgment against defendant for refund of the taxes, delinquency penalty and interest so paid for said period in the amount of \$8,383.10, plus interest as provided by law.

## VIII.

Plaintiff is entitled to judgment against defendant for its costs of suit herein to be taxed by the Clerk of this Court.

## IX.

Plaintiff was the “employer” of the employees of White-Ahlgren Company, Inc., between March 9, 1954, and September 17, 1954, within the meaning of §§ 1621(d), 1622(a) and 1623 of the 1939 Internal Revenue Code, as amended.

## X.

Plaintiff is liable to defendant for the payment of the Withholding taxes for the period between March 9, 1954, and September 17, 1954, required to be deducted, withheld and paid by said §§ 1622(a) and 1623, and defendant is entitled to judgment that plaintiff take nothing herein with reference to the taxes and interest so paid by plaintiff for said period.

## XI.

All findings of fact which are or are deemed to

be conclusions of law are hereby incorporated in these conclusions of law.

### Judgment

In accordance with the foregoing findings of fact and conclusions of law, It Is Hereby Ordered, Adjudged and Decreed that:

(1) Plaintiff have judgment against defendant for refund of Federal Insurance Contributions Act taxes, delinquency penalty and interest paid by plaintiff to defendant in the amount of \$10,278.37, plus interest as provided by law.

(2) Plaintiff have judgment against defendant for refund of Federal Unemployment Act taxes and interest paid by plaintiff to defendant in the amount of \$4,113.39, plus interest as provided by law.

(3) Plaintiff have judgment against defendant for refund of Withholding [216] taxes, delinquency penalty and interest for the period between December 7, 1953, and March 8, 1954, paid by plaintiff to defendant in the amount of \$8,383.10, plus interest as provided by law.

(4) Plaintiff have judgment against defendant for its costs of suit taxed by the Clerk of this Court in the amount of \$188.50.

(5) Plaintiff taking nothing with respect to Withholding taxes and interest paid by plaintiff to defendant for the period between March 9, 1954, and September 17, 1954.

Dated: This 5th day of December, 1960.

/s/ PEIRSON M. HALL,  
United States District Judge.

Receipt of copy acknowledged.

Lodged November 2, 1960.

[Endorsed]: Filed December 5, 1960.

Entered December 6, 1960. [217]

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[Title of District Court and Cause.]

### BILL OF COSTS

Judgment having been entered in the above-entitled action on the 6th day of December, 1960, against Defendant, the clerk is requested to tax the following as costs:

#### Bill of Costs

Fees of the clerk.....	\$ 15.00
Fees of the marshal.....	5.50
Fees of the court reporter for all or any part of the transcript necessarily obtained for use in the case.....	77.50
Fees for witness (itemized on reverse side) ..	7.20
Fees for exemplification and copies of papers necessarily obtained for use in case .....	
Docket fees under 28 U.S.C., 1923.....	30.00
Cost incident to taking of depositions (*See Below) .....	71.55
<hr/>	
Total .....	\$206.75



## \*Deposition of Harry L. Summers

(original only) .....\$28.80

## Deposition of Robert A. Oakes

(original only) ..... 27.00

## Deposition of Charles E. Sands

(original only) ..... 15.75

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\$71.55

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State of California,

County of Los Angeles—ss:

I, Arthur H. Deibert, do hereby swear that the foregoing costs are correct and were necessarily incurred in this action and that the services for which fees have been charged were actually and necessarily performed. A copy hereof was this day mailed to Laughlin E. Waters, U. S. Atty.; Edw. R. McHale, Asst. U. S. Atty.; Eugene N. Sherman, Asst. U. S. Atty., 808 Federal Bldg., Los Angeles 12, Calif., with postage fully prepaid thereon.

Please take notice that I will appear before the Clerk to tax said costs on the 12th day of December, 1960, at 10:00 a.m.

/s/ ARTHUR H. DEIBERT,  
Attorney for Plaintiff.

Subscribed and sworn to before me this 7th day of December, A.D. 1960, at Los Angeles, California.

[Seal] /s/ DOROTHY ERBEN,  
Notary Public.

My Commission Expires September 28, 1963.

Costs are hereby taxed in the amount of \$7.20 this 27th day of December, 1960, and that amount included in the judgment.

JOHN A. CHILDRESS,  
Clerk, U. S. Dist. Court,  
So. Dist. of Calif.

Witness Fees (computation, cf. 28 U.S.C. 1821 for  
statutory fees)

Name and Residence: Hertha C. White, 5349 Rhea  
Avenue, Tarzana, California.

Attendance

Days: 1.

Total Cost .....\$4.00

Mileage

Miles: 40.

Total Cost ..... 3.20

Total Cost Each Witness .....\$7.20

Total .....\$7.20

[Endorsed]: Filed December 7, 1960.

[Title of District Court and Cause.]

OBJECTIONS TO PLAINTIFF'S  
BILL OF COSTS

To the Clerk of the Above-Entitled Court:

Comes Now the defendant and objects to the  
taxing of the following items of cost claimed in  
plaintiff's Bill of Costs filed December 7, 1960:

1. Fees of the Clerk.....\$15.00
2. Fees of the Marshal.....\$ 5.50  
(to the extent that such fees were incurred prior to joinder of issue)
3. Fees of the Court Reporter for transcript obtained for use in the case...\$77.50
4. Docket fees .....\$30.00
5. Cost incident to taking of depositions.\$71.55

Said objection is made upon the ground that each of said alleged items of cost is not allowable as a cost under Title 28 U.S.C. §2412(b), [221] which provides as follows:

“In an action under subsection (a) of section 1346 or section 1491 of this title, if the United States puts in issue plaintiff’s right to recover, the district court or Court of Claims may allow costs to the prevailing party from the time of joining such issue. Such costs shall include only those actually incurred for witnesses and fees paid to the clerk.”

Objection to the taxing of the fees claimed for the court reporter (\$77.50) is also made upon the ground that no portion of the transcripts or partial transcripts of trial were “necessarily obtained for use in the case” within the meaning of Title 28 U.S.C. §1920(2).

LAUGHLIN E. WATERS,  
United States Attorney;

EDWARD R. McHALE,  
Assistant U. S. Attorney,  
Chief, Tax Division;



EUGENE N. SHERMAN,  
Assistant U. S. Attorney,

/s/ EUGENE N. SHERMAN,  
Attorneys for Defendant,  
Robert A. Riddell.

Receipt of Copy acknowledged. [222]

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Dec. 30, 1960.

Eugene N. Sherman, Esq.,  
Room 808, U. S. Post Office & Courthouse Bldg.,  
Los Angeles 12, Calif.

Arthur H. Deibert, Esq.,  
Suite 1104, 523 W. 6th St.,  
Los Angeles, Calif.

Re: Century Indemnity Co., a Corp. vs. R. A.  
Riddell, Int. Rev. No. 959-58 PH

Gentlemen:

This is to inform you that today the Clerk taxed costs in the above case in favor of plaintiff against defendant in the amount of \$7.20.

Under local court rule 15(c) a review of this decision may be taken to the court on motion to re-tax, by either party, upon written notice thereof, served and filed with the clerk within five days after the costs have been taxed but not afterward.

Pursuant to 289 U. S. 373, Moore Ice Cream Co. vs. Rose, the filing of a Certificate of Probable

Cause, as was done in the present case, converts the suit against the District Director into a suit against the Government. As such it is subject to the limitations of 28 U.S.C. 2412(b), so that only fees actually incurred for witnesses and fees paid to the clerk subsequent to joining of issue may be taxed.

Only the \$7.20 paid to witnesses may properly be taxed therefor under Sec. 2412(b).

Very truly yours,

JOHN A. CHILDRESS,  
Clerk.

By EDW. F. DREW,  
Chief Deputy. [224

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[Title of District Court and Cause.]

### ORDER RE-TAXING COSTS

Upon consideration of plaintiff's motion to re-tax costs, memoranda submitted by counsel for the parties hereto, and oral argument upon said motion on January 16, 1961:

It Is Hereby Ordered, Adjudged and Decreed, that said motion be and it is hereby granted and that the following costs be taxed in favor of plaintiff against defendant: [241]

Fees of the Clerk.....	\$ 15.00
Fees of the Marshal.....	5.50

Fees of the Court Reporter for all or any part of the transcript necessarily obtained for use in the case.....	77.50
Fees for witnesses.....	7.20
Docket fees under 28 U.S.C. 1923.....	27.50
Costs incident to taking of depositions.....	55.80
	<hr/>
Total .....	\$188.50
	<hr/> <hr/>

Dated: January 18th, 1961.

/s/ PEIRSON M. HALL,  
Judge.

Approved as to form.

LAUGHLIN E. WATERS,  
United States Attorney,

By /s/ EUGENE N. SHERMAN,  
Assistant United States At-  
torney.

Receipt of Copy acknowledged.

[Endorsed]: Filed January 18, 1961. [242]

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[Title of District Court and Cause.]

### NOTICE OF APPEAL

To: The Above-Named Defendant and His Attorneys, Laughlin E. Waters, United States Attorney for the Southern District of California; Edward R. McHale and Eugene N. Sherman, Assistants United States Attorney for Said



District, 808 Federal Building, Los Angeles 12,  
California:

You, and Each of You, Are Hereby Advised that the plaintiff, The Century Indemnity Company, in the above-entitled action, does hereby appeal to the United States Court of Appeals for the Ninth Circuit from the part of the judgment entered December 5, 1960, in paragraph (5) thereof holding that plaintiff take nothing with respect to [244] Withholding taxes and interest paid by plaintiff to defendant for the period between March 9, 1954, and September 17, 1954.

Dated: This 2nd day of February, 1961.

/s/ ARTHUR H. DEIBERT,

/s/ A. L. BURFORD, JR.,

Attorneys for Plaintiff.

Acknowledgment of Service attached.

[Endorsed]: Filed February 2, 1961. [245]

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[Title of District Court and Cause.]

#### NOTICE OF CROSS-APPEAL

Please Take Notice that the defendant, Robert A. Riddell, District Director of Internal Revenue for the Los Angeles District of California, does hereby cross-appeal to the United States Court of Appeals for the Ninth Circuit as follows:

(a) from those portions of the judgment entered

in the civil docket, December 6, 1960, in the above action which decreed that:

(1) Plaintiff have judgment against defendant for refund of Federal Insurance Contributions Act taxes, delinquency penalty and interest paid by plaintiff to defendant in the amount of \$10,278.37, plus interest as provided by law.

(2) Plaintiff have judgment against defendant for refund of Federal Unemployment Act taxes and interest paid by plaintiff to defendant in the amount of \$4,113.39, plus interest as provided by law.

(3) Plaintiff have judgment against defendant for [247] refund of Withholding taxes, delinquency penalty and interest for the period between December 7, 1953, and March 8, 1954, paid by plaintiff to defendant in the amount of \$8,383.10, plus interest as provided by law.

(4) Plaintiff have judgment against defendant for its costs of suit taxed by the Clerk of this Court in the amount of \$188.50.

(b) from the Order Re-Taxing Costs in the amount of \$188.50, filed and entered January 18, 1961.

Dated: February 3, 1961.

LAUGHLIN E. WATERS,  
United States Attorney;

EDWARD R. McHALE,  
Assistant U. S. Attorney,  
Chief, Tax Division;

EUGENE N. SHERMAN,  
Assistant U. S. Attorney,  
/s/ EUGENE N. SHERMAN,  
Attorneys for Defendant.

Certificate of Service by Mail attached.

[Endorsed]: Filed February 3, 1961. [248]

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[Title of District Court and Cause.]

STATEMENT OF POINTS APPELLANT THE  
CENTURY INDEMNITY COMPANY IN-  
TENDS TO RELY ON ON APPEAL

Appellant, The Century Indemnity Company, a corporation, intends to rely on the following points on its appeal herein to the above-entitled Court:

(1) The Trial Court erred in finding that Plaintiff had control of the payment of the wages of the employees of White-Ahlgren Company, Inc., for the services rendered by said employees between March 9, 1954, and September 17, 1954.

(2) The Trial Court erred in finding that Plaintiff was the employer of the employees of White-Ahlgren Company, Inc., between March 9, 1954, and September 17, 1954, within the meaning of §§ 1621 (d), 1622(a) and 1623 of the 1939 Internal Revenue Code, as amended.

(3) The Trial Court erred in holding that Plaintiff take nothing with respect to withholding taxes and interest paid by Plaintiff to Defendant for the period between March 9, 1954, and September 17, 1954.



Dated: April 21, 1961.

DEMPSEY, THAYER,  
DEIBERT & KUMLER,  
By /s/ ARTHUR H. DEIBERT,  
Attorneys for Appellant, The  
Century Indemnity Co.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed April 21, 1961. [257]

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In the United States District Court, Southern  
District of California, Central Division  
No. 959-58-PH Civil

THE CENTURY INDEMNITY COMPANY,  
Plaintiff,  
vs.

ROBERT A. RIDDELL, Etc.,  
Defendant.

Honorable Peirson M. Hall, Judge Presiding.

REPORTER'S PARTIAL TRANSCRIPT  
OF PROCEEDINGS

Tuesday, September 20, 1960

Appearances:

For the Plaintiff:

DEMPSEY, THAYER, DEIBERT &  
KUMLER, by  
A. L. BURFORD, JR., ESQ.; and  
ARTHUR H. DEIBERT, ESQ.

For the Defendant:

LAUGHLIN E. WATERS,

United States Attorney, by

EUGENE SHERMAN,

Assistant United States Attorney.

EVA L. COLE

called as a witness by and on behalf of the plaintiff, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name in full, please.

The Witness: Eva L. Cole; C-o-l-e.

The Clerk: Your address, please.

The Witness: 548 South Spring Street, Los Angeles 13.

Direct Examination

By Mr. Burford:

Q. Mrs. Cole, I would like to ask you just a few questions, preliminary questions, to set your background.

I believe you are in the insurance business?

A. I am.

Q. What is the name of your company?

A. Cole Insurance Agency, Inc.

Q. About how long have you been in the insurance business?      A. All my life.

Q. What type of insurance do you handle?

A. All lines of insurance.

The Court: Without touching upon a delicate subject, let us say how many years' experience you have had in the insurance business. [21\*]

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\*Page numbering appearing at top of page of original Reporter's Transcript of Record.

(Testimony of Eva L. Cole.)

The Witness: 44 Years.

Q. (By Mr. Burford): Have you ever represented any insurance companies? A. Yes, sir.

Q. Were you authorized agent for The Century Indemnity Company in 1953? A. Yes.

Q. Now, Mrs. Cole, you are of course familiar with this subcontract which is between Marine Development and White and Ahlgren, Inc., which is Plaintiff's Exhibit 1-B in evidence. A. Yes.

Q. Now were you contacted by any representative of White and Ahlgren, Inc., the subcontractor, with reference to procuring a surety bond?

A. Yes.

Q. Who contacted you?

A. Both Mr. Ahlgren and Mr. White.

Q. Do you know approximately when that was?

A. Around the 1st of October, 1953.

Q. Had you met either of these gentlemen before? A. Yes.

Q. What were the circumstances under which you met them, just briefly?

A. I had met Mr. Ahlgren in connection with other contract [22] bonds for a firm known as Wright-Ahlgren Company. At the time of this job Mr. White was brought in and the name had been changed from Wright-Ahlgren to White and Ahlgren. That is when I met Mr. White for the first time.

Q. What procedure do you normally follow when someone comes to your office and requests a surety bond?



(Testimony of Eva L. Cole.)

A. We would have to have a financial statement which must qualify for the bond, and then we have to investigate the background and find out whether they have the ability to do the work. The companies require a minimum of 10% in current assets to write a bond, not only on the job, but the work on hand.

Q. What procedure did you follow in connection with this application?

A. We requested an up-to-date financial statement, and it was brought in. The assets were sufficient but there was not enough cash to start the job.

So it was submitted to The Century Indemnity Company and they advised me that they would have to have \$25,000 more cash than the statement showed.

Q. This is the statement of White and Ahlgren?

A. Yes.

Q. Who did you submit this application on behalf of?

A. To the manager of the bond department at The Century Indemnity Company, Mr. Waite. [23]

Q. Is that D. J. Waite? A. D. J. Waite.

He submitted it to his home office who, in turn, notified him that although White and Ahlgren had considerable assets, some of their current assets were deferred, that they couldn't get hold of their money immediately.

Mr. Sherman: Your Honor, I move to strike that portion of the witness' answer which pertains to what the home office told Mr. Waite as hearsay.

(Testimony of Eva L. Cole.)

The Court: I think it is hearsay.

Q. (By Mr. Burford): Mrs. Cole, just state what you know of your own knowledge. What did Mr. Waite tell you?

A. He told me that his home office needed a minimum of \$25,000 additional cash.

Q. Then what did you do?

A. I relayed the information to the contractor and then I dropped the subject until they came to me later on.

Q. Until what?

A. I dropped the matter until they came to me later on.

Q. About when was this?

A. A short while later. Mr. White came to see me and wanted to know whether it was possible for us to accept money that was loaned to them.

Q. When you say "us"— [24]

A. I mean the White and Ahlgren Company.

And I told them that was possible if the people loaning money to the contractor would subordinate the money until the job was completed and the bond was exonerated.

Q. Then what did he do?

A. He mentioned to me at the same time that he knew of a party who would loan the corporation, his company, \$15,000 but the loan was subject to the money being in the job and being assured that the money would be used in the job.

Mr. Sherman: May I have that last answer read back, please.

(Testimony of Eva L. Cole.)

(Record read.)

Mr. Sherman: I move to strike that again as hearsay. Obviously this testimony is being offered to show what some third party not present stated the conditions would be to their offering money in the company. I don't think that this witness is qualified to pass on the truth of that, it is being offered for the truth, and therefore it is hearsay.

The Court: Objection overruled.

Q. (By Mr. Burford): Now, Mrs. Cole, what did you do as a result of this conversation?

A. I told Mr. White that the only way that the party could be assured that the money would be used in the job is by [25] having all monies under joint control, and I suggested that they handle it through a professional joint control company, that I didn't feel qualified to handle it.

He left and he brought me a Mrs. Clausen, a week later or thereabouts, and she was the person who was going to loan the money, but again she wanted to make sure that the money would be used on the job, and I told her that the only way that she could be sure that the money would be used on the job was that it would be held under joint control.

Q. Did you explain to her or to Mr. White what you meant by "joint control"?

A. I only told them that all monies would be paid through that account, that a special account



(Testimony of Eva L. Cole.)

would have to be opened and all monies would be paid through that account, that that was all I understood about joint control and I wasn't experienced enough to give out more information.

Q. As a result of that conversation what then happened?

A. I told Mr. White that \$15,000 was not sufficient to meet the company's requirements, that another \$10,000 would have to be raised.

He told me that then he thought they could borrow on their equipment another \$10,000, and I told them it was up to them to work out their problems, and I dropped the matter until they came out later and told me they had made arrangements [26] to borrow \$10,000 on their equipment, and that Mrs. Clausen was willing to loan \$15,000 provided this \$25,000 would be put under joint control, and the money was not deposited by Mrs. Clausen until the morning the bond was written and she wouldn't deposit the money in the account until the other \$10,000 was available.

Q. Now you did submit a new application to The Century Indemnity Company as a result of this?

A. Yes.

Q. And the date of that is shown on the exhibit as December 2, 1953?

A. Yes.

Q. Now returning to this joint control problem again——

The Court: Just a moment. The application I have here, Exhibit 2, is dated October 6, 1953.

(Testimony of Eva L. Cole.)

Mr. Burford: I stand corrected, your Honor. The contract started then. It was October.

The Witness: The application was submitted to me at that time.

The Court: October 6?

The Witness: Yes, when they first came to me.

Q. (By Mr. Burford): That is the application?

A. That is the application, yes. [27]

Q. And on the basis of which the bond was ultimately written? A. Yes.

The Court: Then the money wasn't deposited until December 2nd. Is that right?

The Witness: Correct.

The Court: That is, \$25,000?

The Witness: Yes.

The Court: In the Security Trust & Savings Bank at San Diego?

The Witness: Yes.

Q. (By Mr. Burford): In connection with that account, Mrs. Cole, will you describe how that was set up?

A. Well, the account was opened the morning that I brought the bond out in San Diego to whereby White and Ahlgren would authorize the payment, approve the bills, sign the checks, and I would countersign them.

Q. In what capacity were you countersigning?

A. As trustee for The Century Indemnity Company.

Q. Did you have discussions with anyone repre-

(Testimony of Eva L. Cole.)

sending The Century Indemnity Company in connection with your signing this account as trustee?

A. I talked with Mr. Waite about it and they had nothing to do with this joint control, it was a requirement of [28] Mrs. Clausen. The only reason I used the company is because I had no standing with any bank, and I had told the contractor that they would not accept a joint control with me personally as I was not in the business. So therefore in order for a bank to accept a joint control they would have to have a responsible person, and I approached Mr. Waite and asked his permission to handle it through The Century Indemnity Company, and he consented to it.

Q. With whom did you deal at the bank.

A. Mr. Frazier.

Q. Now, Mrs. Cole, on the first signature card, which I believe is Exhibit 4-A, you are shown there as signing as a secretary of the company, I believe.

A. That was a mistake. I recall that, and I told Mr. Frazier that I was not the secretary, and he was supposed to correct it.

Q. In other words, this is where you signed on the line just above the word "secretary"?

Mr. Sherman: May I see where it is?

(Exhibiting document to counsel.)

The Witness: Yes.

The Court: And that was superseded by a new card on December 8th.

Mr. Sherman: Dated December 2nd.



(Testimony of Eva L. Cole.)

The Court: It is dated on this card, [29] Exhibit 4-A, December 8, 1953, "Superseded by New Card," and while this statement on the back here is dated 12-2-53, nevertheless it states on the front of the card December 8, 1953.

Is there any question but what the 4-B superseded 4-A on December 8th?

Mr. Sherman: No.

Mr. Burford: No question.

The Court: Very well; let us get on.

Q. (By Mr. Burford): Mrs. Cole, at no time then, if I understand your testimony, were you an officer in any capacity for White and Ahlgren, Inc.?

A. No.

Q. Now on these signature cards, at least 4-A and 4-B, there is a notation, 548 South Spring St., Los Angeles, California. Do you know what that is?

A. That is my office.

Q. That is your office? A. Yes.

Q. In other words the statements were to be sent to you? A. Yes.

Q. Who kept the checkbook on this White and Ahlgren Trust Account No. 1 at this time?

A. I did. [30]

Q. Do you know if there were other checkbooks?

A. I don't know.

Q. But you at least had one?

A. I had one.

Q. Now will you please explain to the Court briefly your understanding of the arrangement between you then acting as trustee and White and

(Testimony of Eva L. Cole.)

Ahlgren, Inc., as to how you were to handle checks.

The Court: What were you trustee of?

The Witness: I beg your pardon?

The Court: What were you a trustee of?

The Witness: The joint control account.

The Court: You were trustee of Mrs. Clausen's money and the \$10,000 that was raised?

The Witness: That is right. I explained to her that although I was not an expert in joint control, I had handled a few when I used to work for a company and that the usual procedure was that all monies were deposited in an account and all bills were paid out of that account, and in this particular case, since I wasn't getting any money for it, to save time I suggested to Mrs. Clausen that I send a check for the gross amount of payroll every week, which would eliminate my having to go to San Diego once a week to pay all the employees and that they were to let me know what amount was needed, and I would countersign the check to save time and mail it to [31] them, and for them to deposit it in their own general account, and they would meet the payroll out of that account.

That is what they did for several months.

Then all the other bills would be sent to me approved by the contractor and I would make the check out in accordance with the amount that they had approved and countersign it, send it over to them for their signature. The fact that I had the book in my office was purely to save time and correspondence and letters.

(Testimony of Eva L. Cole.)

Q. (By Mr. Burford): Now, Mrs. Cole, these were weekly payrolls? A. Yes.

Q. Going back over your testimony just a minute, just taking a particular payroll, the week ending December 18th just as an example——

A. Yes.

Q. ——you received from the bookkeeper of the company what?

A. I would get—I don't remember exactly what took place but I used to get—a telephone call, as I remember it, telling me the amount that was needed for the whole week's payroll, and I would fill out that amount and send it on to them. The agreement was that they were to send me a list of the employees that they had paid, the amount paid to each employee to account for that money, and every week they would [32] mail this payroll recapitulation which would account for the money I had sent to them.

Q. Now at the beginning of the contract, what was the arrangement for covering the payroll, was that one check or individual checks?

A. One check.

Q. To whom was that payable?

A. White-Ahlgren Company.

Q. How did this work out?

A. Well, it worked out fine until I got a statement from the bank in February, in which was listed so many employee payroll checks that I hadn't countersigned, and I immediately called Mr. Frazier and asked him what the meaning of it was,



(Testimony of Eva L. Cole.)

since I hadn't countersigned the checks, how come they had honored it on that particular account.

He explained to me that a mistake had been made, so he told me that he wanted to be released of all liability as to this mistake.

I was fearful that I couldn't get another bank to take the account, so I had to release him, but White-Ahlgren promised that they would make up the difference in that particular account.

They were also supposed to use their other assets to finance the work because the \$25,000 was just a minimum amount and they had supposedly other assets to finance this [33] work. The bonding Company wasn't supposed to finance the work.

So they paid the checks out of the weekly gross check that I sent them, but some time the latter part of March I had received some phone calls from banks that checks were received with NSF on the White-Ahlgren employee checks.

Q. What do you mean by "NSF"?

A. Not Sufficient Funds—on employees that, according to the list that they had sent me, I had mailed a check in the gross payment that I had made to them.

So I immediately called White-Ahlgren and asked them the meaning of it. They had no explanation except the fact——

Mr. Sherman: At this point, your Honor, I will object. I didn't want to interrupt the testimony of the witness, but whenever the witness refers to the fact she had a conversation with White-Ahlgren I

(Testimony of Eva L. Cole.)

think for the record we should specify who she spoke to.

The Court: Yes, I think so.

If you will excuse me, Counsel, the Land Commissioners are in recess and wish a conference with me.

We will have a short recess.

(Short recess.)

The Court: You may proceed.

Mr. Burford: I wonder if you would read back the last [34] question and answer.

(Record read.)

The Court: When you called White-Ahlgren, the objection was that you should state who you talked to.

The Witness: Usually it was the bookkeeper, Mrs. Higgins.

Q. (By Mr. Burford): In this particular instance we are referring to?

A. I believe I talked with Mr. Waite. I don't recall exactly.

Q. That is in connection with these checks marked NSF?      A. Yes.

Q. Now, Mrs. Cole, let me go back just a minute so we can refresh our recollection on this testimony to date.

In connection with the payrolls themselves, you wrote a check in these early payrolls for the gross

(Testimony of Eva L. Cole.)

amount of the wages as shown on this recap furnished you?

A. They would call me and give me a gross amount that they wanted, and I sent them a check and they had to account for that money.

Q. Where was that check deposited, do you know?      A. I don't know.

Q. To whom was it made out?

A. White-Ahlgren Company. [35]

Q. Did you have anything to do with writing the individual payroll checks during this early period?      A. No.

Q. Then you testified, I believe, that you received a bank statement?      A. Yes.

Q. And this bank statement indicated to you that things hadn't been going the way you had anticipated?

A. Yes. I checked up when I found out that the bank had honored checks without my counter-signature.

Q. You found out about that when you received the bank statement?      A. That is right.

Q. Now, Mrs. Cole, I would like to show you Plaintiff's Exhibit 25, which is a letter signed by you under date of January 15, 1954, addressed to the Security-First National Bank of San Diego, attention Mr. Frazier.      A. Yes.

Q. This letter states—perhaps I should read it for the record:

“Confirming our telephonic conversation relative to the above account, as trustee for The Century



(Testimony of Eva L. Cole.)

Indemnity Company, I hereby approve the payment of payroll checks——”

The Court: I have read the letter. If you have some [36] questions to direct to her, you may ask them.

Mr. Burford: Fine.

Q. Mrs. Cole, will you explain to the Court the circumstances under which you wrote that letter?

A. I went to San Diego because of the fact that these checks had been honored by the bank without my countersignature, and the bank wanted to be relieved of liability, and they requested a letter, and while I was in San Diego I wrote a letter, and I found out at that time that the bank had printed some prior checks to be used——

Mr. Sherman: One moment.

I will object to this and ask that it be stricken. It is again hearsay by this witness and it is beyond the scope of the question asked, what she found out or heard that the bank had or had not done, which is not within the scope of this witness' knowledge until she so establishes it.

The Court: The objection is overruled.

The Witness: I found out that they had printed checks in their possession marked “Payroll Account No. 1,” I think it was, so Mr. Frazier wanted some authority and I wrote this letter.

Q. (By Mr. Burford): This is a letter you referred to in your earlier testimony?

A. Yes.

Q. Ratifying the cashing of these checks with-

(Testimony of Eva L. Cole.)

out your [37] signature or any other trustee signature on it?       A. Yes.

Mr. Burford: If your Honor please, at this time I would like to introduce in evidence as Plaintiff's Exhibit next in order as one group the checks in question which were written on the White-Ahlgren Trust Account No. 1 without the countersignature of any trustee.

The Court: Are they described in your pre-trial order?

Mr. Burford: No, your Honor, they aren't referred to in there.

What we would like to do upon stipulation of counsel at this time is to introduce these checks, at the end of the trial substitute a list of the checks just indicating the basic data.

Mr. Sherman: I have no objection to that procedure, your Honor.

The Court: I think your last number is 35 so we will call that Exhibit 36.

(The documents referred to were marked as Plaintiff's Exhibit No. 36 and received in evidence.)

The Court: How long did this practice continue where you sent them a check for the gross amount of each week's payroll?

The Witness: That was until the latter part of March when [38] I discovered that checks were being paid and without funds, although I had already sent them the money, so I notified them at

(Testimony of Eva L. Cole.)

that time that if I had to pay the employees twice that the only recourse I had was to give them individual checks.

Mr. Sherman: Excuse me. May we again determine, your Honor, who she means by "they"?

The Court: Yes.

The Witness: The contractor.

The Court: Who did you call?

The Witness: White-Ahlgren.

The Court: Mr. White or Mr. Ahlgren?

The Witness: Mostly Mr. White. Mr. Ahlgren was very ill and I didn't talk to him very often at that time.

Q. (By Mr. Burford): Now, Mrs. Cole, I am not quite sure you understood his Honor's question. I believe his question was not when did you start writing individual checks, but when did you start writing checks for the net payroll rather than the gross payroll.

The Court: No, I didn't understand anything about the gross payroll. I understood her testimony to be that when the account was first opened she signed the individual payroll checks.

The Witness: Weekly, one weekly check for all of the [39] employees payroll.

The Court: The account was opened on December 2, 1953?

The Witness: Yes, your Honor.

The Court: Then until the latter part of March you issued one check for the gross amount of the weekly payroll to White-Ahlgren, is that right?



(Testimony of Eva L. Cole.)

The Witness: Yes, your Honor.

The Court: Then your practice changed?

The Witness: It changed the latter part of March when checks were not being honored.

The Court: All right.

Q. (By Mr. Burford): What did you do then?

A. Then I would go to San Diego and the contractor, either Mrs. Higgins or Mr. White, would have the checks all prepared for my countersignature, and I would countersign them and leave.

Q. These were individual payroll checks?

A. Individual to each employee.

Q. They of course would be the net amount due on the payroll?

A. I don't know. I had no record.

Q. Now, Mrs. Cole, in connection with your countersigning checks, just how did you determine what checks to sign other than payroll checks about which you have testified? [40]

A. My agreement with Mrs. Clausen was that Mr. White or Mr. Ahlgren would approve the disbursement and I would countersign their check.

The Court: That is to say, for materialmen?

The Witness: And labor.

The Court: No, let us talk about materialmen from the beginning.

The Witness: Yes, your Honor.

The Court: From the beginning did you sign separate checks to all accounts other than labor?

The Witness: I countersigned all checks for material approved by White-Ahlgren Company.

(Testimony of Eva L. Cole.)

The Court: From the beginning?

The Witness: From the beginning.

The Court: Not in gross weekly amounts?

The Witness: No.

The Court: And you continued to do that throughout your relationship?

The Witness: I did, your Honor.

Q. (By Mr. Burford): Mrs. Cole, did you ever refuse to countersign any checks upon request?

A. Only when there was no money in the bank.

Q. Did you take any steps to determine whether a particular check was applicable to this particular contract? [41]

A. On the bills that the contractor, White-Ahlgren, sent me it would relate to the job and they would usually mark it "job site," and I would verify that it was the job, we had the money under joint control, and I would countersign the check.

The Court: How do you mean you verified it was from the job?

The Witness: I wanted to make sure that it was material delivered on the job site, on the bond.

The Court: Did you do it other than just looking at the bill or did you go down and check on the job?

The Witness: No, I did not check up on the job. I never went and checked up any material on the job.

The Court: How did you verify it?

The Witness: Purely by the description.

The Court: On the bill?

(Testimony of Eva L. Cole.)

The Witness: On the bill and the bond that I had.

The Court: In other words, you compared the description on the bill with the description of the job and the bond?

The Witness: Yes, your Honor.

The Court: I see.

Mr. Burford: Your Honor, at this time I would like to introduce as Plaintiff's Exhibit No. 10 a letter from Oakes & Horton, attorneys at law, San Diego, addressed to Miss Eva L. Cole, dated March 23, 1954, and signed by Robert A. Oakes. [42]

Mr. Sherman: No objection, your Honor.

The Court: Is that described in your pre-trial order?

Mr. Burford: That is correct, as Exhibit No. 10.

(The document referred to was marked as Plaintiff's Exhibit No. 10 and received in evidence.)

Q. (By Mr. Burford): Mrs. Cole, directing your attention to about the middle of March, 1954, did you receive any communication from Marine Development, Inc., or any representative of that company in this subcontract? A. Yes.

Q. What was that?

A. Mr. Summers called for a meeting of a representative of The Century Indemnity Company and myself for Monday morning at 9:00 o'clock in Camp Pendleton. He called me at 12:30 on a Saturday and I tried to contact Mr. Waite and I couldn't reach him so I went alone.



(Testimony of Eva L. Cole.)

Q. What happened at that conference?

A. The meeting was to call upon the company that the contractor was behind schedule in their work and they wanted them to step up their operations, and the letter came forward from Mr. Oakes, which you showed to me, and I turned it over to the bonding company for their disposition.

Q. In other words, you are referring now to the letter, [43] Plaintiff's Exhibit 10, which is addressed to you?      A. Yes.

Q. You turned that over to the bonding company?      A. Mr. Waite.

Q. Mr. Waite?      A. That is right.

Q. Then what did you do then?

A. From then on——

The Court: That is this letter, Exhibit 10?

Mr. Burford: Yes, your Honor.

The Witness: Yes, sir.

Then the company decided——

Q. (By Mr. Burford): What did you do then?

A. The matter was turned over to the company for handling.

The Court: To the bonding company?

The Witness: To the bonding company.

Q. (By Mr. Burford): Did that end your action as a trustee for the bonding company?

A. Not immediately. I went to San Diego with Mr. Van Tassel, the counsel for The Century Indemnity Company, and we handled, I believe he and I, I should say, handled a joint control for a couple of weeks longer, as I remember, but then

(Testimony of Eva L. Cole.)

we were short of money and the company went and took the matter over, and I had nothing more to do with it, about a month or so later, the latter part of April or May. [44]

Q. In other words, that ended your connection with the joint control account on the countersigning of checks and any activity in connection with this subcontract? A. Yes.

Q. Now, Mrs. Cole, did anyone ever compensate you for acting as trustee on this joint control account? Were you ever paid for acting as trustee?

A. No, not at all.

The Court: What was the source of the money that went into this account upon which you drew checks?

The Witness: The payments from the job.

The Court: Was there first \$15,000 and \$10,000 deposited?

The Witness: \$25,000 was deposited.

The Court: That was the original source?

The Witness: That was the original source.

The Court: And thereafter payments from the job went into that account?

The Witness: Yes, your Honor.

Q. (By Mr. Burford): Now, Mrs. Cole, during the time that you were connected with this particular subcontract, did you ever have anything to do with the personnel of White-Ahlgren Company, Inc., in connection with hiring or firing?

A. None at all. [45]

(Testimony of Eva L. Cole.)

Q. Did you ever attempt to exercise any such authority?      A. I never did.

Q. In connection with the payment of checks to the men working on the job where the individual payroll checks were made out, did you do that primarily at the office of the company at Pendleton?

A. I didn't prepare the checks at any time. They were prepared when I arrived there. Who prepared them, I don't know.

The Court: Did you ever see any of the persons to whom these checks were made out?

The Witness: None at all. I saw them on the job but I never talked with them.

The Court: I mean, did you have a check made out to Juan Martinez and did you ever see anyone you knew as Juan Martinez?

The Witness: No, I did not, your Honor.

Mr. Burford: I believe that is all, your Honor.

\* \* \*

### Cross-Examination

By Mr. Sherman:

Q. Mrs. Cole, I believe you testified that you acted as the agent for Century Indemnity Company in the writing of this bond, is that correct?

A. Yes.

Q. And you were paid for your services in that regard, were you not?      A. I didn't hear you.

Q. You were paid for your services in that regard, were you not?



(Testimony of Eva L. Cole.)

A. I had a commission on the bond.

Q. Yes?           A. Yes.

Q. And that was the payment for your services, was it not?           A. That is right.

Q. Now I believe you further testified that in connection with seeking the bond, the officers of the White and Ahlgren Company submitted a financial statement through you to Century Indemnity Company, is that correct?           A. Yes.

Q. The assets shown on that financial statement were all fixed assets, were they not, in the form of machinery and [52] equipment?           A. No.

Q. The financial statements submitted show that they had assets other than fixed assets such as machinery and equipment?           A. Yes.

Q. What did it show in that regard?

A. I don't remember the exact figures, but the current assets over and above the current liabilities were at least 10 per cent of the amount of the bond.

The Court: In other words, the bond was——

Mr. Sherman: \$540,000 or thereabouts, your Honor.

The Court: So their assets were approximately \$54,000, is that right?

The Witness: Yes.

\* \* \*

By Mr. Sherman:

\* \* \* You say that the current assets exceeded the current liabilities by an amount of at least 10 per cent in excess of the amount of the bond.

(Testimony of Eva L. Cole.)

Is that correct? [53]

A. The current assets?

Q. Yes.

A. Not only the net assets, but the current assets were in excess of 10 per cent of the amount of the bond.

Q. What do you define as current assets?

A. Any monies or accounts receivable that can be liquidated in a short time.

Q. I believe you further testified that you acted as trustee in behalf of The Century Indemnity Company with reference to this joint control account?

A. Yes.

Q. And it is also a fact, Mrs. Cole, that Century Indemnity Company required the opening of a joint control account as a condition to its writing of the bond?

A. No.

Q. You are positive of that?

A. I am positive.

Q. I believe you testified that it was at Mrs. Clausen's request that the joint control account was opened.

A. It was a request that money be put in the job and I found no other solution except handling it through joint control.

Q. And therefore it was for her protection then that the account was opened?

A. Yes. [54]

Q. In supervising the account you were to act as sort of protector for her monies?

A. I was supposed to act as disbursement agent.

Q. Did you ever consult with Mrs. Clausen with

(Testimony of Eva L. Cole.)

reference to what disbursements from the trust account were to be approved or not approved?

A. I called her a couple of times and she didn't seem to understand anything about business practices, so I discontinued calling her because she didn't understand business, what a joint control consisted of, apparently.

Q. So you had no further discussions with her?

A. I had to use my best judgment. I felt a moral obligation to her.

Q. Did you ever submit to her any accounting or statement as to what disbursements were approved from the joint account?

A. She understood that——

Q. Would you please answer my question: Did you ever submit any such statements or accountings?

A. No.

The Court: Why didn't you?

The Witness: She was present at several meetings and she was there and she knew what was going on.

Q. (By Mr. Sherman): Did you ever, Mrs. Cole, discuss with Mrs. Clausen [55] Plaintiff's Exhibit 36, this whole series of checks which did not contain your countersignature?

A. As I remember, she was there when the matter came up.

Q. What do you mean by "there"?

A. She was at San Diego.

Q. Where?

A. At the office of White and Ahlgren.



(Testimony of Eva L. Cole.)

Q. She was at the office of White and Ahlgren when that came up, you say?

A. As I remember.

Q. What do you mean by the matter coming up?

A. When these checks had been honored by the bank without any countersignature.

Q. And you had a discussion at the office of White and Ahlgren concerning that?

A. I had the discussion with Mr. White over the telephone first. Then the next day I went to San Diego.

Q. When was this?

A. I don't recall the exact date. It is when I discovered that the checks were cashed without any countersignature.

Q. This was after you got the bank statement?

A. Yes.

Q. Was Mrs. Clausen present at that conversation? [56]

A. As I remember, she was. I am not positive, though.

Q. Did you ever discuss directly with her what had taken place with regard to these checks from the point of view of the monies she had put in the joint control account?

A. I don't remember.

Q. As best you remember, did you not discuss it with her personally?

A. I don't remember.

Q. Mrs. Cole, I now hand you that which has been marked Defendant's Exhibit B for identification, and that purports does it not, to be instructions to the Security Trust and Savings Bank of

(Testimony of Eva L. Cole.)

San Diego re White-Ahlgren Trust Account No. 1 under date of December 2, 1953, does it not?

A. Yes.

Q. And at the bottom thereof in the right-hand corner there appears to be what purports to be the signature of Eva L. Cole as attorney in fact for The Century Indemnity Company. Am I correct? A. Yes.

Q. Is that your signature? A. Yes.

Q. Would you please, Mrs. Cole, refer to the second paragraph of these instructions and that second paragraph reads as follows, does it not: [57]

“The title to said account, and any balance that may be therein at any time is hereby vested and declared to be held by the aforesaid trustee and attorneys in fact of The Century Indemnity Company, as security to The Century Indemnity Company that all funds to the credit of said account at any time shall be used solely for the purpose of paying bills for labor and material and all obligations entering into a certain construction project with reference to the completion of which said Century Indemnity Company has executed an indemnity bond.”

Am I reading it correctly? A. Yes.

Mr. Sherman: Offer into evidence as Defendant's Exhibit B, your Honor.

The Court: May I see it?

(The exhibit referred to was passed to the Court.)

(Testimony of Eva L. Cole.)

The Court: It is admitted.

(The document referred to was marked as Defendant's Exhibit B, and received into evidence.)

The Court: Is this Mr. Waite's signature appearing on there? [58]

The Witness: Yes, your Honor.

The Court: Who is Mr. Waite?

The Witness: He is the manager of the bond department of The Century Indemnity Company.

The Court: In Los Angeles?

The Witness: In Los Angeles.

Q. (By Mr. Sherman): Mrs. Cole, Defendant's Exhibit B, these instructions to the bank, they were submitted to the bank, were they not, at the time the joint control account was opened?

A. Yes.

Q. I now show you what has been marked Defendant's Exhibit C for identification, Mrs. Cole, and that is a power of attorney of The Century Indemnity Company? A. Yes.

Q. And the power of attorney names you as an attorney in fact for The Century Indemnity Company, does it not? A. Yes.

Q. And was this power of attorney submitted to the bank at the time the joint control account was opened? A. I don't remember.

Q. You don't remember? A. No. [59]

Mr. Sherman: Offer it into evidence as Defendant's Exhibit C, your Honor.



(Testimony of Eva L. Cole.)

The Court: Let me see it.

(The exhibit referred to was passed to the Court.)

The Court: Any objection?

Mr. Burford: No objection.

The Court: Admitted.

(The document referred to was marked as Defendant's Exhibit C, and received in evidence.)

Q. (By Mr. Sherman): Mrs. Cole, I now hand you Plaintiff's Exhibit 10 in evidence. That is the letter addressed to you by Mr. Oakes under date of March 23, 1954, which you have previously testified about? A. Yes.

Q. This is the letter that was written to you at the time that there was difficulty in White-Ahlgren's meeting of its schedule of work performance? A. Yes.

Q. And this letter refers, does it not, to a conference held in the offices of the Marine Development Company at which offices of Marine Development were present officers of White-Ahlgren, and the letter states you were present as [60] attorney in fact for The Century Indemnity Company, does it not? A. Yes.

Q. I now hand you, Mrs. Cole, that which has been marked Plaintiff's Exhibit 24 for identification. That is a subordination agreement, is it not?

A. Yes.

(Testimony of Eva L. Cole.)

Q. Whereby Hertha A. Clausen subordinated any rights she had against White-Ahlgren for her loan to the rights of Century Indemnity Company?

A. In the amount of \$15,000, yes.

Q. And was that subordination agreement executed by you as attorney in fact for The Century Indemnity Company?      A. Yes.

Mr. Sherman: Offer into evidence as Defendant's Exhibit, your Honor. Our last exhibit in the pre-trial order is Exhibit T, so, perhaps, this should follow.

The Court: Well, it is marked No. 24 as a plaintiff's exhibit, so it can go in under that number. It doesn't make any difference.

Mr. Sherman: Very well.

The Court: It is admitted in evidence.

(The document referred to was marked as Plaintiff's Exhibit No. 24, and received in evidence.) [61]

Q. (By Mr. Sherman): As a matter of fact, Mrs. Cole, all of these documents show, do they not, that you acted for Century Indemnity Company with reference to all your dealings with the White-Ahlgren Company, including the joint control account?      A. Yes.

The Court: Did you negotiate and secure the execution of this Exhibit No. 24, this subordination agreement by Mrs. Clausen?

The Witness: Yes, your Honor.

The Court: You prepared it?

(Testimony of Eva L. Cole.)

The Witness: It is a printed form.

The Court: I mean, there is some typing in here.

The Witness: Yes. She was in my office and I prepared it for her.

The Court: You had it typed in and submitted to her for signature?

The Witness: That is right, yes.

Mr. Sherman: Would you mark this?

The Clerk: Defendant's Exhibit U, marked for identification.

(The document referred to was marked as Defendant's Exhibit U for identification.) [62]

Q. (By Mr. Sherman): Mrs. Cole, I show you now that which has been marked Exhibit U for identification. That is a letter under date of January 8, 1954, addressed to the White-Ahlgren Company by yourself, is it not?

A. I didn't hear you; I am sorry.

Mr. Sherman: Would you read the question?

(Question read.)

The Witness: Yes.

The Court: Before you get onto that, in connection with this Exhibit No. 24, I notice that it is signed "Contractor," and typed in "White-Ahlgren Company, Inc., W. T. Ahlgren, President," which is typed underneath the signature, and "Creditor," and the signature Hertha A. Clausen, but over on the left side it says "Witness," and



(Testimony of Eva L. Cole.)

the signature Hertha A. Clausen, and Secretary-Treasurer.

Mr. Sherman: I will come to that in my examination, if your Honor wishes to wait.

The Court: We are here now.

Why did she sign that as secretary and treasurer? Was she secretary and treasurer of the White-Ahlgren Company, or how did you happen to write that in there?

The Witness: On the 2nd day of December, 1953, when I went to the office of the White-Ahlgren Company to bring the bond, I told them at that time that the application had to be [63] signed by a president and attested by the secretary.

They had no secretary. I told them that they had to have one. So they appointed Mrs. Clausen as secretary-treasurer.

The Court: Right then?

The Witness: Right then.

The Court: Did they fire her right then, or did she continue, or do you know?

The Witness: I don't know.

The Court: There wasn't any resolution of the Board of Directors?

The Witness: They claimed they had one.

The Court: Very well.

Q. (By Mr. Sherman): This letter, Mrs. Cole, dated January 8, 1954, that you have in your hands, that was written by you to the White-Ahlgren Company, was it not?      A. Yes.

Q. And that letter refers, does it not, to things

(Testimony of Eva L. Cole.)

that The Century Indemnity Company might require you to do in connection with the joint control account?

A. May I have the time to read it, please?

Q. Certainly.

A. (Examining document): Yes.

Mr. Sherman: Offer it into evidence as [64] Defendant's Exhibit U, your Honor.

The Court: Let me see it.

(The exhibit referred to was passed to the Court.)

The Court: It is admitted.

(The document referred to was marked as Defendant's Exhibit U, and received in evidence.)

Q. (By Mr. Sherman): Now, Mrs. Cole, with reference to Mrs. Clausen's appointment as secretary-treasurer of the White-Ahlgren Company, did I understand that that took place at the time that the bond was executed and the joint control account was opened?

A. I believe it was the same day, as far as I can remember.

Q. Now, was the application for bond also executed at the same time?

A. I don't remember. An application was submitted earlier when a Mr. Curtis was secretary of the company at that time, but I don't know whether

(Testimony of Eva L. Cole.)

I took another application as of the date of the bond.

Q. Now, Mrs. Cole, I show you Plaintiff's Exhibit 2 in evidence.

That is the application for bond that you [65] previously testified about, is it not? A. Yes.

Q. On Page 4 thereof, it is signed by Hertha Clausen as secretary, is it not? A. Yes.

Q. And the date of this bond is October 6, 1953, is it not? A. The application.

Q. The application—pardon me—the date of this application is October 6, 1953? A. Yes.

Q. Yet if Mrs. Clausen was not appointed secretary-treasurer until the date the bond was executed, was then not this application executed not on October 6, 1953, due at the time the bond was written in December of 1953?

A. I don't remember.

Q. As a matter of fact, Mrs. Cole, all of these papers, the bond, the subcontract and the application for bond, were all actually executed at the time the joint control account was opened, is that not correct?

The Court: All except the application, did you say?

Mr. Sherman: No. I said all of them, the subcontract, the bond and the application for bond were all actually executed in December when the joint control account was opened. [66]

Q. Is that not correct?

A. That is possible; I don't remember.



(Testimony of Eva L. Cole.)

Q. Now, Mrs. Cole, the subordination agreement that you testified about, Plaintiff's Exhibit 24, was that not required by The Century Indemnity Company?      A. Yes.

Q. As a matter of fact Mrs. Clausen's loan to the company in the amount of \$15,000 went directly into the joint control account, did it not?

A. Yes.

Q. And Mr. Earl Grandy also made a loan to White-Ahlgren, did he not?      A. Yes.

Q. In the amount of \$25,000?      A. Yes.

Q. And that also went into the joint control account, did it not?      A. Yes.

Q. At the time the joint control account was opened, the contractor, Marine Development Company, also deposited \$10,000 into the joint control account, did it not?      A. Yes.

Q. And that made up the balance of the original \$25,000 deposited, did it not?      A. Yes. [67]

Q. Mrs. Clausen's \$15,000 and Marine Development's \$10,000?      A. Yes.

Q. And Marine Development's \$10,000 was an advance on the progress payment, is that correct?

A. Yes.

Q. Now before the joint control account was set up, did you discuss with Mr. Waite or Mr. Ahlgren the source of the monies that were to be put into the joint control account?

A. I don't remember.

The Court: You testified yesterday that you had discussed with them, one or the other, the proposi-

(Testimony of Eva L. Cole.)

tion that they didn't have sufficient assets to write the bond and that one of them came to your office and said he knew somebody who would loan them the money and they brought the woman in?

The Witness: Yes.

The Court: So then you must have discussed it.

The Witness: I discussed the amount needed that the bonding company required, and then they asked me whether if someone loaned money.

The Court: Then the answer to the last question should be changed, should it not?

Read that last question.

(Record read.) [68]

The Witness: The source is what I don't remember about.

The Court: Didn't you testify that they brought Mrs. Clausen in, and she said she was going to loan them \$15,000?

The Witness: Not first, your Honor, I didn't know what the source was. I thought that is what counsel was referring to.

The Court: What do you mean by the source?

The Witness: He wanted to know—He asked me where the source of the money came from. I didn't know.

The Court: It came from Mrs.—

The Witness: Clausen and—

The Court: He isn't asking you where Mrs. Clausen got it, he is asking you who it came from

(Testimony of Eva L. Cole.)

to go to White-Ahlgren, the source. It was Mrs. Clausen's \$15,000, wasn't it?

The Witness: Yes, and another \$10,000 was supposed to be put in. I didn't know the source of that one.

The Court: You didn't know that the Marine Development put it in?

The Witness: Until the last minute I didn't know.

The Court: But you did know that Mrs. Clausen was going to put in \$15,000?

The Witness: I knew that.

The Court: And you had discussed that with the officers of White-Ahlgren?

The Witness: Yes. [69]

Q. (By Mr. Sherman): Mrs. Cole, I now hand you that which has been marked Defendant's Exhibit A for identification.

That purports to be a letter under date of November 16, 1953, addressed to Marine Development, Inc., and signed by D. J. Waite, attorney in fact of The Century Indemnity Company, is it not?

A. Yes.

Q. Have you ever seen this letter before?

A. No, except I saw it when Mr. Deibert showed it to me.

Q. Have you ever seen this letter prior to the time that the joint control account was opened?

A. I don't remember it.

Q. As best you recall, did you or did you not see it?

A. I did not see it.



(Testimony of Eva L. Cole.)

Q. Did you ever discuss this letter or its contents with any member or officer of the White-Ahlgren Company before the joint control account was opened up?      A. I don't remember.

Q. The best of your recollection is that you did not?

A. I did not, as far as I can remember.

Q. Now that letter requires the opening of a joint control account as a condition precedent to Century Indemnity [70] Company's writing of the bond, does it not?      A. Yes.

Q. So this is a condition, the opening of the joint account is a condition, according to this letter before Century will write the bond, is that correct?

A. I think so; I am not sure.

The Court: It calls for a conclusion, Counsel.

Mr. Sherman: Yes.

I offer into evidence Defendant's Exhibit A, your Honor.

The Court: Any objection?

Mr. Burford: No objection.

The Court: It is admitted.

(The document referred to was marked as Defendant's Exhibit A, and received in evidence.)

Q. (By Mr. Sherman): Now, if I understood your testimony correctly, you did not know the Marine Development Company was to put in \$10,000 into the joint control account until it was actually done?      A. No.

(Testimony of Eva L. Cole.)

Q. Is that correct? A. Correct.

Q. Do you know who deposited the initial [71] Marine Development \$10,000 check into the joint control account?

A. It was brought to me the morning that the account was opened.

Q. That was the first you knew about it?

A. That is right, as far as I can remember.

Q. And you deposited it into the joint control account? A. Yes.

Q. And thereafter did you deposit the checks of Marine Development Company into the joint control account?

A. Most of those checks were mailed direct to the bank.

Q. Did you ever deposit any of them yourself?

A. I believe once or twice they were handed to me and I mailed them to the bank, or took them to the bank, I don't remember.

Q. You are positive that you handled them once or twice? A. As far as I can remember, yes.

Q. Now with reference to Plaintiff's Exhibit 36, which are these checks which do not contain your countersignature, they covered a relatively short period of time, did they not, just a few weeks?

A. I don't remember.

Q. The first one is dated December 18, 1953? [72]

A. Yes.

Q. And the last one is dated January 7, 1954?

A. Yes.

Q. Now you testified, I believe, that you okayed

(Testimony of Eva L. Cole.)

those checks after you got the bank statement in February, is that correct?

A. I don't recall the date.

Q. It first came to your attention after you got the bank statement in February? A. Yes.

Q. That is when you first discussed it with Mr. Frazier, is that not correct? A. Yes.

Q. Mrs. Cole, I now hand you Plaintiff's Exhibit 25. This is the letter you testified about wherein after the matter came to your attention you ratified the issuance of these checks?

A. (Examining exhibit): Yes.

Q. Now that letter is dated January 15, 1954, is it not? A. Yes.

Q. And that was before you got the bank statement in February, was it not?

A. The letter was written after I had received the bank statement. [73]

Q. You mean the letter was backdated?

A. No, sir.

Q. Can you then tell us how the letter was dated January 15, 1954?

A. Then I must have received the bank statement prior to that date.

Q. You received the bank statement prior to January 15, 1954? A. Yes.

Q. For the month of January?

A. That is what I had before me. That is the first inkling I had that checks were cashed without any countersignature.

The Court: Well, here is a check dated January



(Testimony of Eva L. Cole.)

12th. It seems to be the latest one. Did you have some arrangement with the bank where you would get bi-monthly statements?

The Witness: I don't remember, your Honor, but I did get the bank statement prior to this letter.

Q. (By Mr. Sherman): As a matter of fact, Mrs. Cole, isn't it true that Mr. Waite discussed these checks with you before you got any bank statement at all? A. No, sir.

Q. Now in connection with these checks, Mrs. Cole, isn't it true that you left trust account checkbooks with the [74] White-Ahlgren bookkeeper, Mrs. Higgins, to enable her to write checks on the trust account?

A. I don't understand your question.

Mr. Sherman: Perhaps we can have the reporter repeat the question.

(Question read.)

The Court: You mean signed by Mrs. Cole in blank?

Mr. Sherman: No.

Q. Did you leave blank checkbooks, checkbooks on the trust account, did you leave such blank checkbooks with Mrs. Higgins, the White-Ahlgren bookkeeper, in order to enable her to write out checks against the trust account?

A. I didn't leave them. There were more than one book and they only gave me one.

Q. My question is whether you gave her any such checkbooks? A. I did not.

(Testimony of Eva L. Cole.)

The Court: When you finally countersigned the checks, the practice was for her to draw the checks and send them to you?

The Witness: That was the general practice.

The Court: So she had to have possession of the checks?

The Witness: Yes, she had one checkbook and I had one also. [75]

Q. (By Mr. Sherman): Now I believe you further testified in connection with the checks drawn on the trust account that any checks okayed by White-Ahlgren you automatically countersigned, is that correct? A. Correct.

Q. You did not act in the way of approval or disapproval of any checks they wanted, if they okayed it you okayed it but they had to okay it first, is that correct? A. Yes.

Mr. Sherman: May we have this marked Defendant's Exhibit V for identification, please.

(The document referred to was marked as Defendant's Exhibit V for identification.)

Q. Mrs. Cole, I now hand you what has been marked Defendant's Exhibit V for identification. Those are checks Nos. 386 through 394 on the trust account in blank bearing only the signature of Albert C. White, is that correct? A. Yes.

Q. Is it not a fact, Mrs. Cole, that these blank checks signed in blank by Albert C. White were given by him to you at your request so that you could write further checks against the trust account

(Testimony of Eva L. Cole.)

without any further approval of the White-Ahlgren Company?

A. As I remember it, it was for the purpose of paying [76] off employees in a hurry when they needed some checks fast. I don't remember these checks at all.

Q. When you say you don't remember these checks at all, do you recall that you had these checks in your possession?

A. I don't remember it.

Q. Well, then, how do you know what they were for?

A. If they left me some checks it was for that purpose, as I remember it.

Q. You don't remember whether they did or not, but if they did leave them you know why they left them, is that the idea?

A. I don't remember really.

Q. Now as a matter of fact, if these checks were given to you in that form you would write checks without any further approval of the White-Ahlgren Company?

The Court: That is speculative, Counsel.

Mr. Sherman: Very well, your Honor.

We will offer them in evidence as Defendant's Exhibit V.

The Court: Admitted.

By the way, there doesn't appear to be any foundation laid for them. If there is no objection they may be admitted. I don't know where they came from or is there any showing here as to where



(Testimony of Eva L. Cole.)

they came from or how or why or when White signed [77] them or who had them.

Mr. Burford: If your Honor please, we haven't seen these before. I have no objection to them being admitted with the condition that a foundation be laid by Mr. White when he testifies.

Mr. Sherman: Very well, your Honor.

The Court: The objection will be sustained at this time; there is no foundation laid.

Q. (By Mr. Sherman): Now, Mrs. Cole, when you discussed these checks with Mr. White I believe you said—was it he who promised that the trust account would be reimbursed?

A. No, it was Mr. Ahlgren.

Q. Mr. Ahlgren? A. Yes.

Q. But you were promised that the trust account would be reimbursed, is that correct?

A. Yes.

Q. Now at that time the White-Ahlgren Company——

The Court: The trust account?

The Witness: Yes, your Honor.

Mr. Sherman: Yes, your Honor.

The Court: Well, the first account apparently was White-Ahlgren Account No. 1.

Mr. Sherman: That is the trust account, your Honor. [78]

The Court: The name of it was White-Ahlgren Account No. 1. According to this letter of January 15th, it states:

“So as to eliminate such a future possibility, I

(Testimony of Eva L. Cole.)

have suggested and recommended to White-Ahlgren Company, Inc., that they open in your bank a payroll account under the name of White-Ahlgren Trust Account No. 1, over which I will have no control \* \* \*''

Now let me see the checks. I think they are on the White-Ahlgren account.

Mr. Sherman: May I make an explanation?

The Court: Are these Trust Account No. 1?

(The exhibit referred to was passed to the Court.)

The Court: The exhibit here which you have produced is not the one I had in mind. Where are the instructions to the bank? There is another document there, Mr. Clerk, that was handed up this morning, instructions to the bank or a power of attorney.

Mr. Sherman: I believe I can clarify that matter for the Court.

The Court: Here it is.

Mr. Sherman: The joint control account actually opened was known as the White-Ahlgren Trust Account No. 1. All evidence so far has been pertaining to that joint control [79] account.

The reference in the letter of January 15th by Mrs. Cole that another, a second and separate account be opened with that name, no evidence has been introduced as of this point that any such account was ever opened, and therefore all references to date to White-Ahlgren Trust Account No. 1 per-

(Testimony of Eva L. Cole.)

tains to the joint control account that was opened.

This was a suggestion of Mrs. Cole's in a letter in which she used the same appellation for an account which she recommended, but there is no evidence so far that such a further account was ever opened.

Your Honor will note that the letter itself refers, after the opening "Dear Mr. Frazier; re: White-Ahlgren Trust Account No. 1," so the account was in existence at that time.

The Court. Let me see the cards.

(The exhibits referred to were passed to the Court.)

The Court: I see the White-Ahlgren Trust Account No. 1, and this is the statements which show White-Ahlgren Trust Account No. 1. This is May of 1954.

Mr. Sherman: I think your Honor will see from the opening sheet that it was opened December 2, 1953.

The Court: Yes. Very well.

Well, then, do you know whether or not as a matter [80] of fact White-Ahlgren Company opened another and separate account than the one which had theretofore been carried under the name of White-Ahlgren Trust Account No. 1?

The Witness: I don't know. I asked that a payroll account be opened.

The Court: Did they open a payroll account?



(Testimony of Eva L. Cole.)

The Witness: No, they did not, as far as I know. I don't know.

Q. (By Mr. Sherman): They did, Mrs. Cole, though have their own company account?

A. I didn't know that.

Q. You wrote checks payable to the company, did you not?

A. I made checks payable to that account, but I don't know what they did with it. I don't know if they opened an account or not.

The Court: You made checks payable to what account?

Mr. Sherman: Made payable to White-Ahlgren Company, I believe she testified, your Honor.

The Court: Are those checks going to come in evidence so that we can see without guessing who they were made to?

Mr. Sherman: Well, I don't know if plaintiff intends to introduce them or not. They have possession of them.

The Court: Very well. Go ahead. [81]

Q. (By Mr. Sherman): Now, Mrs. Cole, at the time that the bond was written it was written in connection with this job at Camp Pendleton, was it not?      A. Yes, sir.

Q. Now at that time the White-Ahlgren Company, under the name of Wright-Ahlgren Company also had a job with Webb & Knapp at Claremont Gardens, did it not?

A. I understood so. I don't know for a fact.

Q. Didn't you write insurance for that job?

(Testimony of Eva L. Cole.)

A. I don't remember that I did.

Q. You didn't write the Workmen's Compensation insurance for that job?

A. I wrote Workmen's Compensation after this job started and it covers all jobs, so I wouldn't know which job it covered.

Q. Didn't you write Workmen's Compensation for them before this Camp Pendleton job started?

A. I don't remember if I did. If I did, I don't remember.

Q. Isn't it a fact, Mrs. Cole, that after the Camp Pendleton job started you entered into an agreement with the White-Ahlgren officers that monies in the joint control account could be used to pay the costs of the Webb & Knapp job? [82]

A. No, sir.

Q. Wasn't it the plan, Mrs. Cole, that in return for allowing the use of such monies to be drawn against the trust account, any amounts which Wright-Ahlgren received on the Webb & Knapp job were to go into the trust account to help pay the costs of the Camp Pendleton job?

A. I don't remember anything about that.

Q. Is it your testimony that to the best of your recollection there was no such plan?

A. There was no such plan.

Mr. Sherman: May I have Defendant's Exhibit J.

(The exhibit referred to was passed to Counsel.)

(Testimony of Eva L. Cole.)

Q. (By Mr. Sherman): Mrs. Cole, I show you a check which has been marked Defendant's Exhibit J for identification. Now that is a check made payable to the Director of Internal Revenue in the amount of \$10,397.71, under date of February 17, 1954, is it not?       A. Yes.

Q. And that check bears your signature as trustee, does it not?       A. Yes.

Q. Did you actually write this check out before signing it?

A. I don't remember that. It is possible. [83]

Q. The check is typewritten, is it not?

A. Yes.

Q. Was it your practice when you wrote checks against the trust account to typewrite those checks?

A. I don't remember.

Q. You did countersign the check anyway?

A. Yes, I did.

Q. What was the purpose of the check?

A. I don't know.

Q. You countersigned a check for \$10,000 and you don't know what it was for?

A. They said they owed it to the Internal Revenue.

Q. Did they say what they owed the Internal Revenue for?       A. I understood it was taxes.

Q. Taxes for what?

A. I don't know. I took their word for it. That was my agreement. They were supposed to approve the payment and I was supposed to countersign any check they presented to me if they approved it.



(Testimony of Eva L. Cole.)

Q. So you countersigned this check for \$10,000 without knowing anything further about it other than it was for taxes, is that correct?

A. Yes.

Q. As a matter of fact, you knew this check went to pay [84] taxes owing on the Webb & Knapp job, did you not? A. I did not know.

Q. As a matter of fact, wasn't this check written in order to allow the job to continue and for White-Ahlgren to get its payment out of the Webb & Knapp job? A. I didn't know that.

Mr. Burford: I object to that, your Honor. It is speculative.

Mr. Sherman: I am asking this witness if she knew.

The Court: She said she did not know.

Q. (By Mr. Sherman): But you allowed a check to be drawn against the trust account for payment of taxes, that much you knew?

A. Yes, sir.

Q. I believe you further testified, did you not, that the only——

The Court: When this was presented to you for payment, was there any kind of a return with it, a government form, showing that it was for payroll tax, withholding tax, income tax, excise tax—I don't know how many other kinds of taxes there are, but there are plenty of them.

The Witness: Mr. White told me that they had to have this money immediately to pay the taxes to the United States Government.

(Testimony of Eva L. Cole.)

The Court: In connection with the job covered by your [85] bond or did he mention anything about that?

The Witness: He didn't mention anything about it.

The Court: He just said he had to have it immediately to pay taxes?

The Witness: That is right.

The Court: All right.

Q. (By Mr. Sherman): Now, Mrs. Cole, I believe you testified that the original plan with reference to payment of payroll on the Camp Pendleton job was for you to receive from White-Ahlgren a payroll recap and you would then issue a check to them in the gross amount, is that correct?

A. Yes.

The Court: I think she testified that the custom was for her to telephone her and she would write the check and she would then send her a confirmation.

Mr. Sherman: In the gross amount.

The Court: In the gross amount?

The Witness: Yes, sir.

Q. (By Mr. Sherman): As a matter of fact, didn't that practice of issuing checks in the gross amount stop in January?

A. I don't remember the date, but it stopped.

The Court: You testified yesterday that that continued until the latter part of March, then you signed individual [86] checks for the payroll.

(Testimony of Eva L. Cole.)

The Witness: As I remember, it was in March.

Q. (By Mr. Sherman): Isn't it true, Mrs. Cole, that commencing in January the practice was changed and you issued checks only in the net amount to the payroll until you started individual checks in March? A. I don't remember that.

The Court: Net amount? By that you mean the net due each individual after deducting unemployment insurance, and so on?

Mr. Sherman: Yes, your Honor.

The Court: Or by that do you mean net individual checks as against gross payroll?

Mr. Sherman: I mean, your Honor, checks after deducting the appropriate taxes, the actual checks which the individual employee received.

The Court: Let us first find out when she started the practice of signing individual checks, then find out what those checks were for.

The Witness: As I remember it, it was in March.

Q. (By Mr. Sherman): That you started signing the individual checks? A. Yes.

The Court: Now on those individual checks, did they have [87] anything up in the corner or on the back or a voucher with them that showed the gross amount due, less withholding tax, less income tax, Social Security tax, and so on?

The Witness: I never noticed it, your Honor.

The Court: Were they big checks with a voucher at the bottom? You know what I mean.



(Testimony of Eva L. Cole.)

The Witness: No, they were checks like those.

The Court: They were checks this size (indicating) ?

The Witness: That is right.

The Court: And when they submitted the list to you—I see these checks are in varying amounts, \$64.71, \$91.60, \$73.60—when they submitted this itemized list of individual checks to whom the checks were drawn, did they have a tabulation there showing the total amount due the individual and the deductions which the employer is required to make?

The Witness: On this recap they sent me was the net to the employee, and the taxes, withholding and what not, and I sent them the money for the whole amount, not only for the net but also for the withholding and the unemployment and what have you.

The Court: Everything?

The Witness: Yes.

The Court: Do you have one of those?

Mr. Sherman: I was going to get one.

The Court: Very well. [88]

When you started issuing the individual checks as distinguished from the gross amount——

The Witness: That was, as I remember it, in March.

The Court: But whenever it was that you did do so, before you issued those individual checks I take it that you had a list from them of the names of the persons to whom the money was due?

(Testimony of Eva L. Cole.)

The Witness: Your Honor, the checks were all prepared when I arrived at their office.

The Court: You would go to their office once a week?

The Witness: I would go to their office once a week, to San Diego, and I would go for that purpose.

The Court: Did they give you any list showing the amount, the gross amount and the deductions and the withholdings?

The Witness: None whatsoever.

The Court: So all you did was—they presented you checks and you just signed them?

The Witness: Yes, sir.

The Court: You don't know whether the amounts you signed for included or did not include withholding taxes?

The Witness: I wouldn't know, your Honor.

The Court: Did you ever have any auditor go down and go into their books to see the status of their accounts with the government on the withholding and employment taxes and Social [89] Security?

The Witness: I had asked them that an auditor be appointed. They had no CPA and they had asked me whether I knew of an auditor and, as I remember it, I talked with Mr. Waite about it and since there was a man we knew, both Mr. Waite and myself knew, that auditor was located in Laguna Beach, and I knew he was a responsible man, and so did Mr. Waite.

(Testimony of Eva L. Cole.)

We mentioned his name and suggested his name, but we didn't recommend that they take him, we just happened to know the man, and they hired the man, Mr. Hoover, Rex Hoover, who is a public accountant.

The Court: They hired him?

The Witness: Yes. We had nothing to do with hiring him.

The Court: When was that?

The Witness: That was sometime, as I remember it, the latter part of March.

The Court: Then did he send any report to you or, so far as you know, to anyone in The Century Indemnity Company showing the status of their books and accounts with relation to the amount of money that was due or owing or had been paid or was held on hand by them in connection with any of these taxes?

The Witness: By the time Mr. Hoover went there the job was in trouble and it was out of my hands.

The Court: I see. [90]

Q. (By Mr. Sherman): Mrs. Cole, I hand you that which has been marked Defendant's Exhibit W for identification. Now is that an example of the type of payroll recap that was furnished to you?

A. Yes, sir.

Q. I hand you that which has been marked Defendant's Exhibit X for identification. Is that another example of the type of payroll recap fur-



(Testimony of Eva L. Cole.)

nished to you?           A. Yes, sir.

The Court: What date?

Mr. Sherman: It is a payroll recap for the week ending January 18, 1954. That is Exhibit W, your Honor.

Exhibit X is the payroll recap for the week ending January 25, 1954.

The Court: Let me see them.

(The exhibits referred to were passed to the Court.)

The Court: You did receive these documents?

The Witness: Yes, your Honor.

The Court: Now when you received these was this during the period that you were issuing the gross checks?

The Witness: Yes, your Honor.

The Court: Very well. They are received in evidence.

(The documents referred to were marked as [91] Defendant's Exhibits W and X, respectively, and received in evidence.)

Mr. Sherman: May they be returned to the witness, Mr. Clerk?

(The exhibits referred to were passed to the witness.)

Q. (By Mr. Sherman): Mrs. Cole, would you look at Exhibit W, please, which is the payroll for

(Testimony of Eva L. Cole.)

the week ending January 18, 1954. A. Yes.

Q. On page 2 thereof under the column "Gross" is the total figure, \$4,966.41. Am I correct?

A. Yes.

Q. And under the column "Deductions" is the figure \$594.98. Am I correct. A. Yes.

Q. And under the "Net figure" the total dollar figure \$594.98. Am I correct? A. Yes.

Q. Now with reference to the payroll for that week, the week ending January 18, 1954, did you issue a check in the amount of the gross, which is \$4,966.41 or in the amount of the net, \$4,371.71?

A. Evidently I sent them the net on that week.

Q. You gave them only the net? [92]

A. That particular week.

Q. The week of the 18th? A. Yes.

Q. Would you turn to Exhibit X, which is the payroll for the week ending January 25, 1954?

A. Yes.

Q. Would you turn to the second page there and would you look at the figure under "Gross" and would you look at the figure under "Net"?

A. Yes.

Q. Tell us whether for that week's payroll you issued a check in the amount of the gross or the amount of the net. A. I don't remember.

Q. Do you note on the bottom thereof in handwriting the words "Check No. 133 Paid 1-29-54"?

A. Yes.

Q. Is that your handwriting?

A. Yes, it is.

(Testimony of Eva L. Cole.)

Q. Is it your testimony that Check No. 133 was the check issued to pay the payroll for that week?

A. Yes.

The Court: What week is that?

Mr. Sherman: January 25th.

The Court: This White-Ahlgren Trust Account No. 1 doesn't show any money going into that bank account during the [93] month of January.

Mr. Sherman: Yes, it does.

The Court: It shows \$25,000 originally but on those dates it doesn't show any money.

Mr. Sherman: That is correct, because the check would have cleared thereafter. But let me proceed in that fashion.

The Court: Well, January 18th, it would have cleared before February 1st, would it not?

Mr. Sherman: I have them identified for the Court, and may we establish it through the witness, your Honor?

May we hand the witness, Mr. Clerk, Defendant's Exhibits D and E for identification.

(The exhibits referred to were passed to the witness.)

The Court: Is that another account?

Mr. Sherman: Yes, that is the general account to which account the check was supposed to have been issued.

The Court: Let me see it.

(The exhibit referred to was passed to the Court.)



(Testimony of Eva L. Cole.)

Q. (By Mr. Sherman): Now, Mrs. Cole, would you please look at Exhibit D for identification. That shows that these are the bank ledger sheets of the White-Ahlgren Trust Account No. 1. The first page may be a little blurry but I think the balance of the [94] pages show it. Is that not correct?

The Court: Well, that is what it was admitted in evidence for, as indicating whatever the first date is.

Mr. Sherman: I don't think they have been offered yet. They are still marked only for identification.

The Court: Very well.

Q. (By Mr. Sherman): Now would you turn to the reverse of the first page, Mrs. Cole, the one that commences with the entry January 7, '54. Do you see that? A. Yes.

Q. That shows that this is the White-Ahlgren Trust Account No. 1, does it not? A. Yes.

Q. Now would you look, Mrs. Cole, on the first left-hand column under the date February 15, 1954. Do you find that? A. Yes.

Q. Next to that in the checks issued column do you find the figure \$3,282.54? A. Yes.

Q. Would you please look at Exhibit W. Is that the exact amount of the net for the week ending January 25th? A. W is 4,966.

Q. I mean the X rather than W.

A. Yes. [95]

Q. That is the exact amount?

(Testimony of Eva L. Cole.)

The Court: You mean they got it in the wrong column?

Mr. Sherman: No, your Honor. This check cleared the bank on February 15, 1954.

The Court: Let me see it. I don't understand it.

(The exhibit referred to was passed to the Court.)

The Court: Oh, it cleared it in February.

Mr. Sherman: It cleared the trust account in February, February 15, 1954.

Your Honor will bear in mind this was the payroll ending January 25th, which was paid after that week, and by the time it cleared the bank it was February 15th.

I think I can tie this up by the other things I have in my mind.

If your Honor will look under February 15, 1954, your Honor will see the amount of \$3282.54 clearing the bank on that date, which is the exact amount of the net for the payroll period ending January 25, 1954.

Q. Now, Mrs. Cole, would you please look at Exhibit E for identification. That is the bank ledger sheet of the White-Ahlgren Company account, is that not correct?      A. Yes.

Q. That was the White-Ahlgren own account?

A. I suppose so. [96]

Q. Would you look on page 5 and would you look in the deposit column under the date of February 15, 1954, is that not the amount of \$3282.54?

(Testimony of Eva L. Cole.)

A. February 15th?

Q. Yes, in the deposit column, which is the third column from the right-hand side.

A. (Examining exhibit.)

Mr. Sherman: Your Honor, apparently it didn't come out on this photocopy and therefore at this time I would like to substitute for this photocopy Exhibit E the one I have been working from.

The Court: Very well.

Mr. Sherman: Your Honor will see under date of February 15, 1954, the deposit which I have circled.

The Court: Yes, I see it.

In other words, the course of the check was out of the trust account into the——

Mr. Sherman: General account.

The Court: ——general account.

Mr. Sherman: And from which they were to disburse the wages, and my point to the witness is——

The Court: Did they, in fact, disburse the wages from that account? Is that your position?

Mr. Sherman: No. My point is that the amount transferred to these people was not the gross amount, including the amount [97] of taxes, as this witness has testified, but that commencing in January it was changed to the transfer only of the net amount and the White-Ahlgren Company did not receive the taxes; it merely received the amount of salary less taxes, and this witness has testified that this wasn't the practice and that the gross was paid until individual checks were signed in March.



(Testimony of Eva L. Cole.)

The Court: I am just inquiring. I suppose it will come out in the testimony.

After this was done did White-Ahlgren draw the individual checks to the employee?

Mr. Sherman: Yes, your Honor.

The Court: Out of their general account?

Mr. Sherman: Yes, your Honor. The books so indicate.

The Court: In other words, they ceased paying their employees out of the trust account?

Mr. Sherman: But only for a few weeks, as I tried to bring out from the witness.

The Court: She ceased at the end of January.

Mr. Sherman: The beginning of January or for a few weeks it occurred, and then after that they paid directly to the White-Ahlgren Company who then paid their employees and my point at this time, your Honor, is that commencing in January the amounts transferred were not gross but net less the taxes.

The Court: All right. And your contention is that that [98] continued for how long?

Mr. Sherman: It continued until March when they commenced actually writing the individual checks at the job site.

You see, your Honor, the procedure was in the beginning that they were to write the gross. Then this was changed in January and they merely transferred the net. Then commencing in March there was no longer a transfer of funds to White-Ahlgren from which they were supposed to pay the employ-

(Testimony of Eva L. Cole.)

ees, but commencing in March checks were issued directly against the trust account and countersigned directly at the job site by The Century trustee.

The Court: Deductions being made from the individual employee?

Mr. Sherman: Yes. In other words, commencing in January, your Honor, the deductions did not——

The Court: Commencing in March when they paid the checks to the individual employee, and it was countersigned on the job by a representative of Century Indemnity, it is your contention that they paid only the net amount due that employee and withheld all of the taxes concerning which this claim is involved?

Mr. Sherman: That is correct. It is a further point that this procedure was also followed insofar as withholding the tax amounts as early as January, that as early as January when [99] transfers were made to White-Ahlgren.

The Court: I understand that.

Mr. Sherman: Very well.

Q. Now, Mrs. Cole, does that refresh your recollection that you would issue net checks instead of gross checks?

A. After they had drawn checks which were not countersigned by me apparently, that is what I did. I didn't remember it, though.

Q. Now you testified that this procedure was changed to drawing individual checks against the trust account at the job site in about March.

A. As I remember it, yes.

(Testimony of Eva L. Cole.)

Q. Didn't that occur at the time that Mr. Oakes sent you this letter informing you of White-Ahlgren's default in the matter?

A. I don't remember the exact date.

The Court: Well, in March, I understood a little while ago that things were taken out of your hands.

The Witness: The latter part of March.

The Court: In the latter part of March?

The Witness: Yes, your Honor.

The Court: By some officials of Century Indemnity and you had nothing more to do with the job or the disbursement of funds?

The Witness: I had something to do until the whole job was [100] taken over by the legal department of Century Indemnity. I went there a couple of times.

The Court: I mean about countersigning checks, and so on.

The Witness: I did countersign a few checks after that.

The Court: After they took it over?

The Witness: Yes.

The Court: All right.

Q. (By Mr. Sherman): Now, Mrs. Cole, before they took it over, this letter that Mr. Oakes sent you was sent to you, was it not?      A. It was.

Q. That was before they took it over. Now before they took it over you started the practice of going down to the job site once a week and signing the individual payroll, countersigning the individ-



(Testimony of Eva L. Cole.)

ual payroll checks?           A. Yes.

Q. Now my question is this: You commenced that practice of going down to the job site and signing the individual payroll checks at about the same time that Mr. Oakes sent you the letter advising you that White-Ahlgren was behind in its work schedule?           A. Approximately.

Q. Now is it my understanding that your testimony is that after you commenced issuing individual checks at the job [101] site no further payroll recaps were furnished to you?

A. Yes, no further recaps were made to me.

The Court: Let me get this clear again.

After you received this letter, which is Exhibit 10, a letter from Oakes & Horton, and which changes the schedule of the apparent completion dates of the work, you then changed the practice which you had theretofore followed and went to San Diego each week?

The Witness: Yes, your Honor.

The Court: You went on the job site and signed checks which had been prepared by the White-Ahlgren bookkeeper?

The Witness: Either at the job site or their office.

The Court: One or the other?

The Witness: Yes.

The Court: You signed checks which had been prepared by the bookkeeper?

The Witness: Yes, your Honor.

The Court: And at that time, if I understand

(Testimony of Eva L. Cole.)

you correctly, no schedule such as Exhibits W and X giving the individual names, the hours, the rate, the gross, the deductions and the net, were presented to you?

The Witness: As I remember it, none were presented to me.

The Court: Was any total amount given you, the total payroll?

The Witness: No, I don't recall of any. [102]

The Court: How did you know that the money was going to these people? How did you know that there wasn't a lot of phony names?

The Witness: The purpose of the controller, as I pointed out yesterday, was purely to disburse the funds in accordance with the instructions of the contractor. They are supposed to present the check to me, Mrs. Clausen was satisfied that they were a good risk, she was loaning the money, and as far as the bond is concerned the bonding company expected White-Ahlgren to use their own funds to finance the job, not only the small amount of money that was deposited, they were supposed to finance the job to the extent of about \$50,000 of their own money.

The Clerk: Defendant's Exhibit Y has been marked for identification.

(The document referred to was marked as Defendant's Exhibit Y for identification.)

Q. (By Mr. Sherman): Mrs. Cole, I now hand you that which has been marked Defendant's Ex-

(Testimony of Eva L. Cole.)

hibit Y for identification. That purports, does it not, to be payroll recaps for the weeks ending respectively April 12, 1954?           A. Yes.

Q. April 19, 1954?           A. Yes. [103]

Q. And April 26, 1954?           A. Yes.

Q. Is that correct?           A. Yes.

Q. And each of those payroll recaps are signed by an officer of the White-Ahlgren Company certifying that that is the true and correct amount of payroll for the particular week, is that correct?

A. Yes.

Q. Do each of those payroll sheets bear in the upper left-hand corner the name of Eva Cole? You can take it apart, Mrs. Cole.

A. (Examining exhibit.) Yes.

Q. And were not those payroll recap sheets furnished to you?

A. I suppose so. I don't remember.

Q. Were they not furnished to you after you commenced the practice of signing individual checks at the job site?

A. Possibly. I don't remember them, though.

Q. You don't remember them?           A. No.

Mr. Sherman: At this time, your Honor, we would like to go back a little and offer into evidence Defendant's Exhibits D and E, which are the bank ledger accounts of the two bank [104] accounts.

The Court: They are admitted, as are W, X and Y.

Mr. Sherman: Thank you, your Honor.



(Testimony of Eva L. Cole.)

(The documents referred to were marked as Defendant's Exhibits D, E, W, X and Y, respectively, and received in evidence.)

The Court: Is this your writing up here?

The Witness: No, it is not, your Honor.

Q. (By Mr. Sherman): Now, Mrs. Cole, with reference to your dealings with the personnel or officers of the White-Ahlgren Company, is it not true that Hertha Clausen was appointed secretary-treasurer of the White-Ahlgren Company at your suggestion?

A. I don't remember the exact conversation that took place. All I know is that I needed an application signed by a secretary and I asked them to appoint someone, I didn't care who it was.

Q. Didn't you tell them, in substance, that they needed a secretary-treasurer and Hertha Clausen might as well be it? A. That is possible.

Q. You now say that is possible that you might have said that?

A. I might have said that. I don't remember.

Q. Mrs. Cole, do you remember testifying at a deposition here held in Los Angeles on June 16, 1959, at which your deposition was taken in this case? [105] A. Yes.

Q. Do you recall testifying as follows:

"Q. Then I take it at no time did you suggest that she (meaning Mrs. Clausen) be made secretary-treasurer?

"A. Later on she was brought in and I told

(Testimony of Eva L. Cole.)

them they needed a secretary-treasurer, but I didn't suggest Mrs. Clausen to be secretary-treasurer."

Do you now say that you might have suggested it?

A. I don't remember it.

Q. Can you definitely say now——

The Court: Counsel, let's get on. What is the difference?

Mr. Sherman: I am merely trying to establish the witness' testimony, your Honor.

The Court: The long and short of it is that she doesn't remember. She says she might have said it, she might not have said it, so if you have got some evidence that she did say it, let's get on with that.

Mr. Sherman: Very well.

Q. Now, Mr. Hoover came in as the auditor for the White-Ahlgren Company at about the time that Mr. Oakes sent you the letter we have discussed, Plaintiff's Exhibit 10, is that correct? [106]

A. I don't remember the time.

Q. Wasn't it around the end of March and the beginning of April?

A. I don't recall.

Q. Now whose idea was it, Mrs. Cole, that Mr. Hoover come in as auditor for the White-Ahlgren Company?

A. Both Mr. White and Mr. Ahlgren needed an auditor and they asked me to recommend one, and I didn't want to recommend anyone, and I discussed it with Mr. Waite, and since we knew Mr. Hoover was a good man we mentioned his name, but we didn't recommend him one way or the other.

(Testimony of Eva L. Cole.)

Q. Did Mr. Waite suggest Mr. Hoover to the White-Ahlgren people?

A. He may have mentioned his name, yes.

Q. Mr. Waite at that time was the——

A. Manager of the bond department.

Q. ——manager of the bond department?

A. Of Century Indemnity.

Q. Didn't you indicate to either Mr. White or Mr. Ahlgren that Mr. Hoover was a man who had the approval and respect of the bonding company and he would be the man they should put on the job? A. I don't remember that.

Q. Now Mr. Robert Easton came in as an employee of the White-Ahlgren Company at about the same time, didn't he? [107]

A. I don't remember.

Q. You don't remember Mr. Easton?

A. Mr. Easton was there but I don't recall when he came in.

Q. Was Mr. Easton the cost analyst on the job for the payroll? A. I don't know.

Q. Wasn't he brought in by Mr. Hoover?

A. I think so, but I don't know.

Q. Did Mr. Hoover keep you advised as to the financial condition of White-Ahlgren after he became auditor?

A. As I remember it, he called me and told me that there seemed to be a shortage on the job. That is as far as I can remember.

Q. And he offered you no further financial advice as to what was going on, on the job?



(Testimony of Eva L. Cole.)

A. I don't remember of any.

Q. Did he advise you that they had underbid the contract and would come out short?

A. He explained to me that there had been a wrong set of plans used to bid the job.

Q. Did you tell anybody about that?

A. I discussed it with Mr. Waite, I imagine. I don't remember what I did.

Q. Didn't Mr. Hoover furnish you financial statements [108] that he made pertaining to White-Ahlgren Company after he became their auditor?

A. I don't remember that.

Mr. Sherman: May this be marked as Defendant's next in order.

The Clerk: Defendant's Exhibit Z.

(The document referred to was marked as Defendant's Exhibit Z for identification.)

Q. (By Mr. Sherman): Mrs. Cole, I show you that which has been marked Defendant's Exhibit Z for identification. That purports to be a profit and loss statement for the period April 1, 1953, to March 31, 1954, of the White-Ahlgren Company, does it not?      A. Apparently.

Q. As best you can recollect, did Mr. Hoover furnish this statement to you?

A. I don't remember having seen it before.

Q. You kept in day-to-day touch with Mr. White or Mr. Ahlgren, did you not, concerning the progress of the job?

A. That is difficult to answer yes or no for the

(Testimony of Eva L. Cole.)

reason that if I received a call from creditors then I would call them, sometimes as many as five calls a day, and when I did, if I should receive a call, then I would relay the information to San Diego to the contractor's firm.

Q. The creditors would call you? [109]

A. They would be referred to me by White-Ahlgren. When they were buying material the material houses wanted to make sure that they would get their money and they would be referred to me that the money would be paid, and since I had no advance information from the contractor, then I would call the office and talk to whoever was there, usually Mrs. Higgins, and relay the telephone call I had received.

Q. In other words, White-Ahlgren would tell these creditors that the decision as to whether or not they could pay for it or not was up to you?

A. They didn't say that. They said——

Mr. Burford: I object, your Honor.

The Court: The objection is sustained.

Q. (By Mr. Sherman): Mrs. Cole, didn't you discuss with Mr. White how much yardage the White-Ahlgren Company poured each day on the Camp Pendleton job?

The Court: When, Counsel? At the beginning, afterwards or when?

Mr. Sherman: On a day-to-day basis while Mrs. Cole was acting as trustee. My question is, didn't she on a day-to-day basis, every day or every other day, as a matter of practice speak to Mr. White

(Testimony of Eva L. Cole.)

as to how much cement yardage they had poured on the Camp Pendleton job that day or the prior two days depending on the time? [110]

The Witness: At the end of a month and a half or so, Mr. White would tell me he had so much money coming in and I would ask him how many yards he poured so I could arrive at what the estimate of the money would be.

Q. (By Mr. Sherman): Didn't you ever talk to him as many as five or six times a day concerning the progress of the job?

A. When I would get calls from creditors I would. That wasn't very often, maybe once or twice a week.

Q. Didn't you talk to them almost every day?

A. Generally.

Q. What would you talk to them about every day?

A. Generally material that people would call me about.

Q. This happened every day?

A. Almost all the time.

Q. And as many as five and six times a day?

A. Only once or twice that happened.

Q. Wouldn't you talk to them to find out how things were generally coming along?

A. That is a matter of course. I do that all the time with all my clients.

Q. And they would tell you how the job was progressing?

A. Yes, the routine matters with me.



(Testimony of Eva L. Cole.)

Q. And that would include conversation as to how much cement yardage they poured? [111]

A. Yes. I do that with everybody.

Mr. Sherman: No further questions.

\* \* \*

The Court: Do you have any redirect?

Mr. Burford: Would you like to have it now, your Honor, or would you rather have it after lunch?

The Court: Will it be extensive?

Mr. Burford: No, sir.

The Court: We have ten minutes left. Did counsel want to take the recess now?

Mr. Burford: Not me. I am ready to go.

The Court: Very well.

Mr. Burford: If your Honor please, I might state that a lot of the factual matter brought out on this cross-examination has, in effect, been stipulated to as to what the actual facts are.

### Redirect Examination

By Mr. Burford:

Q. Now, Mrs. Cole, going back to these payroll records just a minute, I think there was some misunderstanding in the question and the testimony as to the records, but you did start issuing a check originally which was made out to [112] White-Ahlgren Company, Inc., for the gross amount of the payroll as given you by telephone or as furnished you on these recaps subsequently sent to

(Testimony of Eva L. Cole.)

you, which are similar to the ones in evidence now?

A. Yes.

The Court: Including the withholding?

Mr. Burford: The original amount was the total amount.

The Court: Including withholding?

Mr. Burford: Including withholding.

The Witness: It was at the beginning, your Honor.

Q. (By Mr. Burford): And that was deposited in the White-Ahlgren account?

A. Yes, as far as I know.

Q. Because it was written to White-Ahlgren?

A. Yes.

Q. And we have the information as set forth showing the deposits and Exhibits D and E showing the drawing on the trust account and a deposit in the White-Ahlgren account, is that correct?

A. Yes.

Q. So the total amount went into the White-Ahlgren general account?

A. Yes.

Q. That was an account which did not require the countersignature of any representative of Century Indemnity? [113]

A. Yes.

Q. So once that money was in that account they could use it for anything they saw fit?

Mr. Sherman: I will object to that as argumentative and speculative as far as this witness is concerned.

Mr. Burford: I will rephrase the question.

Q. Once that money was in the account it could

(Testimony of Eva L. Cole.)

be drawn without the signature of a representative of Century Indemnity?

Mr. Sherman: That calls for a conclusion of this witness.

The Court: Overruled.

The Witness: Yes.

Q. (By Mr. Burford): Now, Mrs. Cole, you further testified that you found that these checks were not being written on the general account at the first here but were being written on the trust account for the individual employees?

A. Yes.

Q. Then when you found that out you wrote the letter to the bank and you discussed it, which is Defendant's Exhibit—

The Court: Well, it is the letter of January 15th.

Mr. Burford: That is the one, yes.

Q. Now after you found that out, that was January 15th? A. Yes. [114]

Q. Now the evidence is that for the payroll of January 18th, as I recall, you started writing net payroll checks? A. Yes.

Q. That is, it was one check? A. Yes.

Q. Payable to White-Ahlgren but for the net amount of the payroll, that is, the gross payroll less taxes? A. Yes.

Q. That amount, the money that you would otherwise have deducted from the employees' pay when the individual payroll checks were written, stayed in the Trust Account No. 1, is that correct?



(Testimony of Eva L. Cole.)

A. Yes.

Q. Which would have been under the joint control? A. Yes.

Q. Now, Mrs. Cole, you testified you started writing individual payroll checks on or about the end of March? A. Sometime in March.

Q. Do you now recall why you started that practice?

A. Because in the weekly payroll check that I would send them some of the employees that had been paid all of that money were unable to cash their check.

Mr. Sherman: Now, your Honor, I do feel this question and the answer that the witness is giving is purely hearsay, purely speculative as to what happened with these checks. [115] This witness has testified she had nothing to do with the handing of these checks to these employees. She knows nothing further than the fact that she made out a check to White-Ahlgren.

This is just trying to get in evidence through this witness that this witness does not properly possess.

The Court: Well, I think the form of the question is calling for a conclusion of the witness on direct examination as to why she did this. She changed the practice, or somebody changed the practice, or rather I should say the practice was changed.

The objection is sustained.

Q. (By Mr. Burford): Mrs. Cole, were you

(Testimony of Eva L. Cole.)

directed by anyone to change your practice with respect to the writing of these payroll checks? I am talking now about the ones which you wrote as one check to cover the entire payroll.

A. I changed it myself.

Q. That was your decision?

A. Because I had to pay the same employees twice.

Mr. Sherman: Your Honor, I will object and ask that the balance of the witness' answer be stricken.

The Court: Motion denied.

The Witness: I had to pay the salary to the same employee twice for the same week because the banks wouldn't honor their [116] checks, and they would call me.

Mr. Sherman: Again, your Honor, I move to strike the witness' answer as not responsive to the question, and as hearsay, speculative and a conclusion of the witness.

The Court: Well, it is all that, but I am going to overrule the objection nevertheless.

Q. (By Mr. Burford): If a payroll check, Mrs. Cole, were not honored by the bank, did the bank notify you of its failure to pay the check?

A. Some employees called me that their checks were not being cashed, and the bank called me that checks were presented without any money for these employees, and I was notified, if I remember correctly, by Mr. White that if these employees were

(Testimony of Eva L. Cole.)

not paid immediately that the unions would fine them double the weekly salary.

Since I had to pay the same men twice for the same week I felt that I should pay them by individual checks myself.

Q. And that is when you started the practice?

A. That is when I started, yes.

Q. The testimony on cross-examination was that this practice started on or about the same time as you received this telephone call from Mr. Oakes?

A. Somewhere around the same time.

Q. Was there any connection insofar as you know between [117] this letter and this practice with respect to payroll checks?

A. None whatsoever.

Q. Now, Mrs. Cole, just a few other questions here. I don't want to unduly burden the Court with this, a lot of these facts have been stipulated to, but we have gotten, I think, some confusion into the record.

With respect to the determination of the payment of checks now, you would receive, if I understand your testimony correctly, a phone call from a material house or supplier and they would say that we have an order here for some materials?

A. Yes.

Q. What did they say to you then?

A. They would call up and find out whether I had money to pay them, that White-Ahlgren had informed them to contact me so they would be sure to get their money, and they would call me



(Testimony of Eva L. Cole.)

to find out if they delivered material on the job site could I pay them.

I said that it was up to the contractor, there is money in the account.

Q. Then what would you do?

A. Then I would call White-Ahlgren and relay the information to them, that such and such a party had called me regarding a bill for material on the job.

Q. What was the purpose of the phone call?

A. Purely to keep them informed that the people had [118] called me.

Q. Then what happened?

A. They would either approve or, if it were not on the job, they would tell me it was not on this particular job, and if it was on this job they would send me a bill or tell me to pay it.

Q. That is what I wanted to know. In other words, you would call them and ask them——

A. Oh, no.

Q. You wouldn't?

A. They would call me.

Q. After the materialman would call you, you would then call Mr. White or Mr. Ahlgren?

A. Yes.

Q. Or some other representative?

A. Or Mrs. Higgins.

Q. And find out whether this was a proper bill?

A. I would relay the information. It was up to them to decide what to do with it.

Q. Then they would tell you?

(Testimony of Eva L. Cole.)

A. They would tell me.

Q. Then you would act accordingly?

A. That is right.

Mr. Burford: Your Honor, at this time I have no further questions. [119]

The Court: Very well.

\* \* \*

### Recross-Examination

By Mr. Sherman:

Q. Mrs. Cole, these materialmen, as I understand it, would call you because White-Ahlgren would tell them to call you to check, is that correct?

A. Yes.

Q. Then you would tell the materialmen that the decision was not yours, but they should check with White-Ahlgren?

A. I would tell them—they wanted to know if there was money in a joint control account to pay their bills—I would tell them there was money but it was up to White-Ahlgren to approve the bill.

Q. And this went on, you said, all the time, that White-Ahlgren would tell them to call you and you would call White-Ahlgren? A. Yes.

The Court: Then you would call White-Ahlgren to tell them you got the call?

The Witness: That is right. [120]

Q. (By Mr. Sherman): Did you ever tell White-Ahlgren the decision is not mine, it is yours, don't refer these people to me?

(Testimony of Eva L. Cole.)

A. The reason for it, Mr. Sherman, is that apparently they couldn't get credit and therefore by referring the material men to me they wanted to assure the materialmen that there was money in the joint control account.

Q. Now with regard to these checks that you would receive calls about, do you know why the individual employee or the banks at which these checks were attempted to be cashed would call you, the trustee, instead of the employer of these men?

A. They had already called the employer, as far as I know, and then they would call me because the employer was unable to take care of it.

The Court: What he is trying to get at is how did they know to call you?

The Witness: Because White-Ahlgren would tell them.

Q. (By Mr. Sherman): Do you know that?

A. The bank would tell me.

Q. Are you guessing or do you know that White-Ahlgren did?      A. The bank knew.

Q. The bank knew but you don't know how they knew? [121]

A. I don't know how they knew, but they called me.

Q. When you say you paid these men twice, as a matter of fact they would be paid once, the original check not having been honored and you having to write another check to cover the dishonored check?

A. I had paid the money to White-Ahlgren al-



(Testimony of Eva L. Cole.)

ready, they used the money and then I had to pay the employee again.

Q. Out of the trust account?

A. Out of the trust account.

Q. This was not taken into account at subsequent payrolls that were submitted?

A. That is right.

Q. Weren't these adjustments made in subsequent payrolls?      A. No, they were not.

Q. You are sure of that?

A. As far as I know, they weren't.

Q. But you had the payroll, didn't you?

A. I know, but the fact remains that it was up to them to let me know what had to be paid.

Q. These adjustments could have been made?

A. They could have been made, but as far as I know they weren't. [122]

\* \* \*

#### DEMONT J. WAITE

called as a witness on behalf of the plaintiff, having been first duly sworn, was examined and testified as follows:

The Clerk: Will you state your name, please.

The Witness: Demont, D-e-m-o-n-t, J. Waite, W-a-i-t-e.

The Clerk: What is your address, please; business.

The Witness: Now it is 3325 Wilshire Boulevard, Los Angeles 5.

(Testimony of Demont J. Waite.)

Direct Examination

By Mr. Burford:

Q. Mr. Waite, what is your present occupation?

A. I am employed by the Glens Falls Insurance Company.

Q. In 1953 and '54 by whom were you employed?

A. The Century Indemnity Company.

Q. What was your position? [125]

A. I was manager of the bonding department.

Q. In that position as manager of the bonding department, did you normally receive applications for bonds?           A. Yes.

Q. Do you recall receiving application for a bond from White-Ahlgren Company?

A. Yes.

Q. I show you Plaintiff's Exhibit 2, which is an application for a bond. Is that the application you received?           A. Yes.

Q. When you receive an application for a bond at that time, Mr. Waite, when you received an application for bond what was your normal procedure?

A. To investigate it, require information to be given to me that would permit us to write the bond applied for.

Q. Did you follow that normal procedure in this application?           A. Yes, sir.

Q. What did you find when you pursued this procedure?

(Testimony of Demont J. Waite.)

A. Well, I don't just exactly know what you are asking for.

Q. Let me rephrase the question.

Upon receipt of the application did you issue the bond immediately?      A. No, sir. [126]

Q. What did you do?

A. Made further inquiries, required further information to be given to me.

Q. What sort of information?

A. Oh, financial information, past experience, work on hand.

Q. After receiving that information did you then issue the bond?      A. No, sir.

Q. What did you do then?

A. Made further inquiries that ultimately did result in issuing the bond. I don't follow your questioning.

Q. Did you impose any requirements in connection with the issuance of this bond?

A. (Pause.)

Q. Strike the question.

A. I don't follow what you were getting at.

Q. Did you find that the application——

The Court: In the interest of saving time, I will permit you to lead the witness here to get to the point.

Mr. Burford: Thank you, your Honor.

Q. Did you require any additional cash as a condition to issuing this bond?

A. Yes, sir. [127]



(Testimony of Demont J. Waite.)

The Court: Why didn't you issue the bond in the first place?

The Witness: Because they didn't have enough money to operate the job.

Q. (By Mr. Burford): How much cash did you require?

A. As I remember it, about \$35,000.

Mr. Burford: May I have Defendant's Exhibit A, Mr. Stacey?

(The exhibit referred to was passed to Counsel.)

Q. (By Mr. Burford): Mr. Waite, I show you Defendant's Exhibit A, a letter from you to Marine Development, Inc., dated November 16, 1953, in regard to the bond. Can you state the circumstances under which that letter was written?

A. As I remember it, the Marine Development Company was under a time element here with the people in Texas who were to loan the money to operate this contract, and while I was not at that time satisfied with the information that had been given me to execute the contract or to authorize it to be executed, I told them, or I think they required or asked if I would write them a letter.

Q. Who is "they" now?

A. The Marine Development Company—if I would write [128] them a letter to indicate upon what basis it would be that I would execute the bond and, as I remember it, this letter was then written.

The Court: That is Exhibit——

(Testimony of Demont J. Waite.)

The Witness: A.

(The exhibit referred to was passed to the Court.)

Q. (By Mr. Burford): Now, Mr. Waite, in that letter you stated on behalf of the company that you would commit yourself to write a bond upon receipt of \$25,000 cash by White-Ahlgren and advance payment of \$10,000 by Marine Development, which specific sum of money was to be deposited in a special bank account at White-Ahlgren Company, Inc., of which we as surety would have joint control.

Can you explain for the Court that requirement of joint control?

A. It had been indicated to me that a person or several people were going to loan money to the White-Ahlgren Company, and it was on that basis that I agreed to write the letter—no, let me go back.

When the money was to be loaned to the company, it was given to me.

Q. By “they,” who do you mean?

A. By Mrs. Cole, that joint control would be exercised [129] over the money for the benefit of the people who were to put the money into the corporation, and knowing, of course, that that in itself would react to the benefit of the surety I incorporated it in the letter as part of my requirement.

But it was not an additional requirement of the company.

(Testimony of Demont J. Waite.)

Q. Do you know whether the \$35,000 referred to was actually put into the company?

A. No, sir; it was not.

Q. Do you know how much was?

A. \$25,000—well, \$15,000 was put into the company and then Marine Development advanced the \$10,000 to get the record straight.

Q. But \$25,000 was put into the joint control account? A. Yes.

Q. And the bond, of course, was issued?

A. That is right.

Q. Now, Mr. Waite, I want to show you Plaintiff's Exhibit 10, which is a letter from Mr. Oakes, attorney for Marine Development Company in San Diego, dated March 23, 1954, addressed to Miss Eva L. Cole.

Did you ever see that letter? A. Yes, sir.

Q. Under what circumstances did you see it?

A. She handed it to me after having received it herself.

Q. After she did that, what did you do?

A. I immediately got in touch with Mr. Van Tassel, who is our attorney, and turned it over to him.

Q. Now, Mr. Waite, I show you Plaintiff's Exhibit 4-D, which is a signature card on the Security Trust and Savings Bank in San Diego, and this shows a signature purported to be yours as one of the trustees on that account. Is that correct?

A. Yes.

Q. This is dated June 11, 1954.



(Testimony of Demont J. Waite.)

Did you ever have occasion, if you recall, to exercise your authority to countersign any checks on this account?      A. Yes, sir.

Q. Would you state briefly under what circumstances?

A. I went down on several occasions on a Friday afternoon to the job office at Camp Pendleton and countersigned the payroll checks.

Q. Did you ever have occasion to sign any other checks other than payroll checks?

A. I really don't recall. There may have been some small other ones.

Q. Just what procedure, briefly, did you follow in [131] countersigning these checks?

A. The checks were all prepared when I got there in the early afternoon and I would be presented with the checkbook and the list of names with amounts due on each and would compare them and countersign the checks.

Q. Then what did you do with the checks after you countersigned them?

A. Gave them to—either left the book there or gave them to the bookkeeper, or Mr. White or Mr. Ahlgren, either one of them who were there.

The Court: When was this?

The Witness: Every Friday afternoon that I went down, sir.

What are you getting at?

The Court: Several occasions on Friday. As I remember, we had a Mexican on the stand and we

(Testimony of Demont J. Waite.)

asked him when last summer he did something, and he said about 4:00 o'clock.

Now you said several occasions on Friday. What Friday, beginning when?

The Witness: Very shortly after we received the Oakes' letter and on occasions when Mr. Van Tassel would not be able to go down on a Friday I continued to go down. I don't know how many times. It was until July or August.

The Court: You did not begin until after the receipt of the Oakes' letter? [132]

The Witness: No, sir.

The Court: At that time did Mrs. Cole then cease her activities in connection with signing?

The Witness: It wasn't immediately, but it was shortly after.

The Court: Signing checks?

The Witness: Yes, sir.

Mr. Burford: This signature card, 4-D, your Honor, is dated June 11th of 1954, on which Mr. Waite appears as one of the trustees.

The Court: It was prior to that letter, wasn't it?

What is the date of the Oakes' letter?

Mr. Burford: The Oakes' letter is March 23rd.

The Court: Were these occasions prior to June that you went down there?

The Witness: I can't remember, sir. I would guess not now that he has brought out the date.

The Court: The signature card was June—the previous one——

Mr. Burford: There is a statement attached to

(Testimony of Demont J. Waite.)

Exhibit B which I referred to right here (indicating to the Court).

The Court: For signature of D. J. Waite, attorney in fact, authority to sign for Century Indemnity Company, see resolution dated 12-2-53 and resolution filed 1-12-54.

Mr. Burford: His signature doesn't appear on the card [133] but we will assume from this that he was an authorized signator and for the purposes of the present case we will so stipulate.

Mr. Sherman: May I say for the record that all assumptions of Counsel are his own?

The Court: You mean you don't want to stipulate?

Mr. Sherman: I don't know, your Honor, that Mr. Waite was an authorized signatory if his name doesn't appear on the card.

The Court: I thought that is what you were trying to prove.

Mr. Sherman: Pardon me.

The Court: I thought that was what you were trying to prove, or one of the things you were trying to prove.

Mr. Sherman: Not with reference to Mr. Waite alone. I think we can prove adequately that each and every one of the representatives who signed as trustees were connected with Century Indemnity Company. That doesn't mean Mr. Waite was authorized to sign right away rather than later. That may be true, I don't know, for purposes of stipulation and representing it to this Court as a fact.



(Testimony of Demont J. Waite.)

Mr. Burford: I will certainly withdraw that. I was just trying to short cut.

The Court: Let me see the exhibits again.

(The exhibits referred to were passed to the Court.) [134]

The Court: Have you got the original cards here? Mr. Sherman, have you got the original cards?

Mr. Sherman: The original cards are in the possession of the bank. At the time we took a deposition of Mr. Frazier, the vice-president of the bank, this deposition is here and his testimony discloses that the copies we have been using are true photostatic copies of the bank's originals.

I believe the exact form in which the signature card shows, your Honor, is the signature card on its face and then stapled to the front of it is what appears to be this insertion on the side which merely is typed and stapled to the front of the signature card. I think that is the way the original actually looks.

The Court: There is another exhibit here which was directed to the bank concerning account number so and so.

Mr. Sherman: Those were instructions to the bank, your Honor. I believe it is Defendant's Exhibit B.

(The exhibit referred to was passed to the Court.)

The Court: Instructions to the bank.

(Testimony of Demont J. Waite.)

Mr. Sherman: In which Mr. Waite's name does appear as a party who should be authorized to sign but, apparently, the signature card does not contain his signature. It merely says for Mr. Waite to [135] sign.

So I guess those are the facts and we can draw whatever conclusions we wish from them.

The Court: This is dated December 2, 1953.

Mr. Sherman: Yes, your Honor.

The Court: I think I will take it as a fact from that, that Mr. Waite was authorized to sign after December 2, 1953.

Mr. Burford: Yes, your Honor.

Mr. Sherman: Very well.

The Court: Proceed.

Q. (By Mr. Burford): Mr. Waite, I believe you testified that pursuant to this authority to sign you did sign payroll checks on occasion and some other checks? A. Yes, sir.

Q. Now, Mr. Waite, where did you sign these checks?

A. In the job office at Camp Pendleton.

Q. While you were in the job office at Camp Pendleton, did you have any contact other than just seeing the men working on this job?

A. No, sir; none whatever.

Q. Did you ever have any authority to hire or fire or set terms of employment? A. No, sir.

Q. Did you ever attempt to exercise any such authority? [136] A. No, sir.

(Testimony of Demont J. Waite.)

Mr. Burford: If the Court please, that is all of our direct examination.

The Court: Cross-examine.

Cross-Examination

By Mr. Sherman:

Q. Mr. Waite, to make sure that I understand you clearly, when they originally applied to you for a bond, you felt they were underfinanced and would not write the bond unless the extra cash was put up? A. That is right.

Q. The original requirement with regard to extra cash was for them to put up \$25,000 and Marine Development to advance \$10,000?

A. May I answer that other than yes or no?

Q. Let me put it this way: Is that what you indicated in this letter? A. Yes.

Q. Now, as a matter of fact, however, you did eventually authorize the issuance of the bond when only a total of \$25,000 was put up?

A. That is right.

Q. Only \$15,000 cash to the company and Marine Development's \$10,000? [137]

A. Yes, sir.

The Court: And you began to sign the checks after the \$25,000 had long previously been spent?

The Witness: I presume so.

The Court: So it was your intention here that the trustee account would not be limited primarily to the expenditure of the \$35,000?



(Testimony of Demont J. Waite.)

The Witness: Oh, no.

The Court: And it was your intention that all money expended by them on that job should go in a joint trust account?

The Witness: Yes, sir.

The Court: A joint account?

The Witness: Yes, sir.

Q. (By Mr. Sherman): Well, then, knowing that they were underfinanced and knowing that they had not even met your original requirements of deposit, didn't you, as the bonding manager for your company insist, as indicated in this letter, that the funds to be expended on the job be subject to the control in part of your company?

A. No, sir. May I answer in my own words now to give you the story?

The Court: You can explain your answer if you desire.

The Witness: My original action was to turn the bond [138] down, and when Mrs. Cole as agent came to me with other plans and financing thoughts that were to be included then I went ahead and said, well, yes, maybe we can work it out on that basis.

Q. (By Mr. Sherman): Regardless of whose idea originally it was—whether Mrs. Cole's or yours—you did adopt this suggestion that you acquire a joint control before you would issue the bond. Is that correct? A. Yes, sir.

Q. As a matter of fact, is it not correct that you made known to the parties concerned that Century

(Testimony of Demont J. Waite.)

would require a joint control account before the bond was written?      A. Yes, sir.

Q. And that is what was told to the Marine Development people. Is that correct?

A. I presume so.

Q. Did you ever have any communication with the Marine Development Company people other than this letter?      A. Well, that letter.

Q. Concerning what you would require?

A. I may have, but I don't remember. I have met them. What was said at the time I do not remember.

Q. What would it be at variance with anything you said in this letter? [139]

A. I am sure it would not be at variance, no, sir.

Q. When you acted as trustee over the joint control account were you countersigning checks on behalf of Century Indemnity, or somebody else?

A. Century Indemnity Company.

Q. Now, at the time when you would appear and countersign these checks at the jobsite, did anyone in White-Ahlgren Company furnish you with payroll recaps showing the amounts due the individual employees?      A. Yes, sir.

Q. And to the best of your recollection was this done on each occasion you went down there?

A. Yes, sir.

Q. Now you learned, did you not, that Mr. Rex Hoover had come to work as auditor for White-Ahlgren after the Oakes' letter of March 23rd?

A. Yes.

(Testimony of Demont J. Waite.)

Q. Prior to that time had you ever met Mr. Hoover?      A. No, sir.

Mr. Sherman: No further questions. [140]

\* \* \*

ALBERT C. WHITE

called as a witness by and on behalf of the plaintiff, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name in full, please.

The Witness: Albert C. White, W-h-i-t-e.

The Clerk: Your address, please.

The Witness: 5349 Rhea Avenue, Tarzana, California.

Direct Examination

By Mr. Burford:

Q. Mr. White, you are the White of White-Ahlgren, I take it?      A. That is right, sir.

Q. What is your present occupation, Mr. White?

A. I am a salesman for a building material manufacturing concern.

Q. Prior to that you were connected with White-Ahlgren?      A. That is right, sir.

Q. Between approximately what dates?

A. I would say my first connection going down to San Diego and becoming connected with them started about October of 1953, I believe.

Q. Just before the commencement of the work on this contract?      A. That is right.



(Testimony of Albert C. White.)

Q. And you were with them during this period?

A. That is right.

Q. What was your connection with the company during this contract?

A. I was appointed the vice-president. That is what my business card said.

Q. What were your actual duties briefly? [143]

The Court: Were you an owner of the company?

The Witness: No, sir. I didn't own any part of it.

The Court: Were you a salaried employee?

The Witness: A salaried man, yes, sir.

The Court: Who owned it?

The Witness: Well, there were some stockholders whom I am not acquainted with that were supposed to be the owners of the company.

The Court: Who ran it?

The Witness: Well, there was Mr. Walter Ahlgren, was the president of it, and his brother was one of the stockholders, although I don't believe he had any say in actually running the company. As far as running the company or directing the company, Mr. Ahlgren was the man responsible for it.

The Court: In other words, you took your orders from Mr. Ahlgren?

The Witness: That is right.

Q. (By Mr. Burford): Who were you with before that, Mr. White?

A. I was with Consolidated Rock Products Company here in Los Angeles.

(Testimony of Albert C. White.)

Q. Perhaps it would be helpful if you would just review very briefly what this work consisted of, this contract.

A. It consisted of placing the concrete for [144] the foundations, the footings or foundations, for this housing tract that Camp Pendleton was having built. It was still a concrete contract. We had nothing to do with any other part of the job other than placing the concrete.

Q. In connection with that work, what sort of materials did you acquire?

A. We used the materials to make concrete, rock, sand, cement. We used reinforcing steel wire, mesh for reinforcing, lumber for forming, nails—that is about the extent of it.

Q. About how many men did you have employed at any one time?

A. I can't really say. I don't remember how many men were on the payroll at that time.

Q. Mr. White, you countersigned with the trustee for Century Indemnity Company a number of checks. Were you familiar with how those payroll checks were handled?      A. I believe so.

Q. Beginning at the first of the contract, will you describe briefly how they were handled at that time?

A. At the beginning of the contract?

Q. Yes.

A. We were under joint control with Century Indemnity, with which we had a trustee. At that time, at the beginning of the job, it was Mrs. Cole.

(Testimony of Albert C. White.)

One of the members of White-Ahlgren who were authorized to sign the check was supposed to [145] sign, and a check was to be countersigned by Mrs. Cole or someone with Century before the check was to be issued.

Q. Were you one of those so authorized?

A. I was; yes, sir.

Q. Now on the original payrolls, where did you get the money for meeting the individual payrolls, the individual employees' payroll that you recall?

A. Will you state that again, sir?

Q. When you started out were individual payroll checks issued that were countersigned by the trustee?

A. Well, the first checks that were written, no, they weren't.

Q. How did that work?

A. That come about through a misunderstanding between——

Q. First explain what happened. Tell the Court what happened before you explain why.

A. I think three, and possibly four, weeks of payroll checks for the employees on that job were written on the Trust Account No. 1 checks and issued by our office signed by myself and Mr. Ahlgren. Is that what you mean?

Q. Yes. In other words, a check for the payroll was written and countersigned by the trustee, deposited in the White-Ahlgren Company, Inc., general account, and then individual payroll checks were written, signed by you and Mr. Ahlgren, which



(Testimony of Albert C. White.)

were drawn on Trust Account No. 1 rather [146] than the general account, is that a correct statement?      A. That is right.

Q. Now you were going to explain.

A. I was going to explain it being a mistake, starting off with the trustee account. I don't believe anyone in our office at that time, and I am definitely sure I did not understand it, the mechanics of how the trustee account was to work.

Now the checkbook was left in our office, and I am sure Mrs. Higgins, our office girl, understood that she was to make out our payroll checks on that particular checkbook which she did, and Mr. Ahlgren and I both signed the checks. They were issued and honored at the bank.

As I say, it was a mistake through purely our office not knowing that the Trust Account No. 1 check was to be written and signed by Mrs. Cole and sent to us and we were to deposit it in our own bank account and write checks.

It was corrected shortly after, I believe the third or fourth week—I am not sure how many weeks we continued that policy until it was corrected.

Q. Now subsequently, as I understand it, individual payroll checks were written to the individual employees on this Account No. 1, Trust Account No. 1?

A. We are still talking about the first three or four weeks?

Q. No, later, when individual checks were writ-

(Testimony of Albert C. White.)

ten and [147] countersigned by the trustee payable to the individual employee.

A. It was still on the Trust Account No. 1 checks, I am sure.

Q. How was that handled? First of all, where were the checks signed?

A. At our job office there at Camp Pendleton.

Q. Were you there upon occasion when they were signed?

A. Most of the time I was, yes.

Q. What was the procedure followed?

A. The procedure was, our girl in the office, Mrs. Higgins, would make a payroll recap taken from the time cards that the various foremen would submit of the men they had on the job.

She would compute the time, make a payroll recap, and it was presented to the representative of the trust account, or Century Indemnity, to whoever it might be that came down to be the counter-signer.

Q. Did you or any other authorized representative of the company sign the checks also?

A. Did I as a representative?

Q. Or another representative.

A. Oh, yes. On many occasions I have signed for the company.

Q. Did you check the payroll before you signed them?

A. Yes. It was a procedure that we followed, to check [148] the various names on the recap.

Q. Well, now, Mr. White, I want to show you

(Testimony of Albert C. White.)

Plaintiff's Exhibit 10, which is the letter from Mr. Oakes to Mrs. Cole of March 23, 1954.

A. (Examining exhibit.) Yes, sir.

Q. Were you aware that such a letter had been written? A. Yes, sir.

Q. Now following this letter of March 23rd, did you ever have occasion to meet with representatives of Marine Development, Inc., in connection with the status of the transaction?

A. Prior to this development?

Q. No, after this letter, at any time—let me put it this way:

Did you have any conferences with representatives of the Marine Development Company in connection with your performance under this contract?

A. Yes; we have.

Q. Do you know about when you had such first meeting?

A. No, I don't remember the date of any meeting. As a matter of fact, our office and their office was about a hundred yards apart on the job site and occasionally we actually met with them right out on the job and discussed the job from day to day.

Q. Did you ever discuss the substance of this letter? [149] For example, this letter is signed by you as vice-president of White-Ahlgren.

A. I don't remember having any discussion with them prior to that letter about the substance of the letter, no, sir.

Q. Well, subsequent to this letter, Mr. White,



(Testimony of Albert C. White.)

this letter refers to a default consisting mainly in the fact that White-Ahlgren Company, Inc., was approximately 75 units behind the construction rate called for in the subcontract.

Now after this letter, which you signed, did you ever have any conference with any representative of Marine Development about your performance under the contract?

A. I was present at a meeting in the Marine Development office when Mr. Van Tassel came down, when we discussed the substance of this letter in connection with Marine Development's complaint that perhaps we weren't getting out as much work as they thought we should.

Q. Do you recall who was present at that conference, or some of the men there?

A. I was present, Mr. Van Tassel was present, Mr. Summers and Mr. Jackson of Marine Development. I don't remember whether anyone else was present or not, sir.

Q. What was the result of that conference, Mr. White, what action was taken as a result of that conference?

A. I believe the outcome of it was—I wasn't present at the latter conference between Mr. Van Tassel and Mr. Oakes— [150] but the result of it was we were allowed to proceed in the construction at a slower rate, and I believe we at that time were on a monthly progress draw as far as monies were concerned, and I believe that it was agreed that we

(Testimony of Albert C. White.)

could have a weekly progress draw if it would benefit us in any way.

Q. Now, Mr. White, you were connected with this contract and performance all during this period until the contract was completed, were you not?

A. That is right, sir.

Q. Other than for the acceleration of progress payments from a monthly to weekly basis and a rescheduling of your performance requirements, what other changes were made in the contract, if you know, in your method of performance?

A. I don't believe there was any other change made in the contract. If you mean that we changed our procedure entirely.

Q. Did you do anything other than that? How did you perform, what did you do; did you continue just as you had, or did you change it, or what?

A. No; there wasn't any change. We continued the job under the present procedure.

Q. Who is "we"?

A. The White-Ahlgren Company.

Q. Now after this conference, Mr. White, did you have occasion to have contact with Mr. Van Tassel representing The [151] Century Indemnity Company in connection with contract matters?

A. Yes, I did. Mr. Van Tassel used to come down on Friday afternoons and countersign the checks and used to come down and go with us into the Marine Development office to draw our progressive check or progressive pay.

(Testimony of Albert C. White.)

Q. And he countersigned checks?

A. Payroll checks, yes.

Q. That would be what sort of checks?

A. Our regular payroll checks and what materials bills that we would have available.

Q. In connection with the payment of material bills, explain how they were paid, if you will, for the benefit of the Court.

A. Well, we would take the——

Q. Who is “we” now?

A. Mr. Van Tassel, myself and Mr. Ahlgren, or whoever happened to be present in the office, would take the total amount of the materials bills that were due and go over them. I don’t believe we ever had the money to pay them all at one time, but we would take the most pressing ones and pay those, and I believe at times we tried to disburse a little money to one or more of the suppliers that seemed to need their money real bad, give them what we could, but we would discuss which were the more pressing bills to be paid and pay those first. [152]

Q. How did you arrive at the decision as to which were the most pressing bills?

A. Well, I am not really sure, it has been quite a little while ago, but I just imagine the same procedure holds true today, the one that is on your back the most is the one you pay.

The Court: The what?

The Witness: The one that is giving you the more preference than any of the rest of them.



(Testimony of Albert C. White.)

Q. (By Mr. Burford): Who determined which one that was?

A. Well, that is a question, too, that is hard to answer. I think we would discuss it among ourselves and more or less all of us generally agree which bill was the most pressing.

Q. Now, Mr. White, do you have any recollection of any discussion down at the job site in connection with the payment of any Federal payroll taxes?

A. Yes, I remember talking to Mr. Van Tassel about it. I don't remember the date, no, sir.

Q. Do you remember what sort of taxes you were talking about?

A. I don't know whether it was the third or the fourth quarter taxes, but it was one of the quarter taxes that was due.

Q. What was the substance of that [153] discussion?

A. Well, in my discussion with Mr. Van Tassel about that at that time, if my memory serves me right, the fact that we didn't have the money to pay it, there wasn't sufficient funds in our account to pay it.

Q. That was the substance of the discussion?

A. Yes.

Q. Now, Mr. White, who had the authority to hire and fire the men working on this subcontract?

A. There was a number of us, Mr. Ahlgren, John Ray, his brother, Bill, myself, Mr. Ahlgren's brother, George Ahlgren.

Q. Were they all employees of the White-Ahl-

(Testimony of Albert C. White.)

gren Company?           A. That is right.

Q. Did anyone else have any such authority other than employees of White-Ahlgren?

A. Actually not any authority, no, sir.

Q. Do you know of any instances in which a representative of The Century Indemnity Company exercised such authority?

A. Not directly, no, sir.

Q. What do you mean by that?

A. In the last part of the job, I would say the last month or six weeks of it, Marine Development—

Q. I am referring now only to Century.

Mr. Sherman: I believe the witness should have an opportunity to explain.

The Witness: Well, let me say this: I don't believe [154] that they ever actually fired anybody directly, no, sir.

Q. (By Mr. Burford): Who is "they" now?

A. I am talking about Century Indemnity.

Q. Go ahead with your explanation. I thought maybe you misunderstood my question.

A. I was going to explain a situation that happened down there in the latter part of the job which, as I say, the superintendent that we had running the job, Marine Development, decided that they didn't like his procedure, they didn't like the way he was running the job, and they called myself and Mr. Van Tassel in for a conference on it, and, of course—I may be getting this story ahead of what you have in mind.

(Testimony of Albert C. White.)

Q. No; that is all right.

A. It was along about the time that they kept wanting to call us to fault, and Mr. Summers then gave us more or less an ultimatum.

Q. Who is Mr. Summers?

A. Mr. Summers is one of the owners of Marine Development, Inc.

They wanted to put a man in by the name of Jones into Mr. Ray's spot as the superintendent, and make him accountable only to Marine Development general project manager, Mr. Frank Jackson which, as I say, they more or less held the club over our heads of a default and left us no [155] other alternative than to make that decision, for which Mr. Van Tassel and myself had to go outside where Mr. Ray and Mr. Ahlgren were waiting for us, and Mr. Van Tassel explained the situation to them of what we would have to do.

That is what I mean when I say "indirectly."

The Court: In other words, he relayed——

The Witness: What Mr. Summers gave us as an ultimatum.

The Court: ——what Mr. Summers told you?

The Witness: Yes, sir.

Q. (By Mr. Burford): That was actually the requirement of Marine Development, Inc.?

A. They did require us to do that.

Q. And that was done? A. Yes, sir.

Q. Do you know whether Marine Development ever declared a default under this contract?

A. Not to my knowledge, they never declared us.



(Testimony of Albert C. White.)

We were never served with a default. I am not sure that you have to be served with some kind of a default paper, some legal paper.

Q. You did complete the contract after complying with Marine Development's requirements to which you have just testified, is that correct?

A. Yes, sir. [156]

Mr. Burford: No further questions.

\* \* \*

### Cross-Examination

By Mr. Sherman:

Q. Mr. White, I show you Defendant's Exhibit A in evidence, a letter by D. J. Waite addressed to Marine Development, Inc., under date of November 16, 1953.

Have you ever seen that letter before?

A. Yes, sir; I have.

Q. Where did you first see it?

A. I believe Mrs. Cole gave me that letter in her office.

Q. Was this before the bond was written?

A. Yes, sir.

Q. Was this at a time when you were attempting to determine under what conditions the bond would be written?      A. That is right.

Q. Did you discuss the contents of the letter with Mrs. Cole at that time?

A. Yes; I am sure we did. Actually this letter was grounds, if we met the conditions here was

(Testimony of Albert C. White.)

whether or not we [157] got the bond. I am sure I did discuss it with Mrs. Cole.

Q. The discussion with her were were the conditions set forth in the letter? A. Yes, sir.

Q. In your discussions with Mrs. Cole did she indicate to you that Century Indemnity would require a joint control account?

A. I believe Mrs. Cole's statement to me, if I remember correctly, is that by having joint control we would probably have a better chance of getting Mr. Waite to okay the bond, or we would have a better chance of getting a bond if we had joint control.

Q. That was the first discussion?

A. In our first discussion, yes.

Q. It was after that first discussion that you saw this letter, is that correct, after you found out what the bonding company had in mind, is that correct?

A. Yes. This letter came after our discussion.

Q. At that time you discussed with Mrs. Cole, did you not, what the bonding company would require as indicated in the letter?

A. As indicated by the letter, yes, sir.

Q. And was it your understanding at that time from your conversation with Mrs. Cole that as per the letter the bonding company would require the joint control account? [158]

Mr. Burford: If the Court please, I assume that this is supposed to be cross-examination, none of this being covered on direct.

(Testimony of Albert C. White.)

The Court: I suppose. I don't know what difference it makes with this witness.

Mr. Sherman: Your Honor, I think we have the witness here and it is proper cross-examination.

The Court: Is there any doubt but what The Century Indemnity Company wanted joint control of this account?

Mr. Sherman: Mrs. Cole testified she has never seen that letter.

The Court: I mean on the part of the plaintiff here. Is there any question but what Century Indemnity wanted to and did have joint control of this account?

Mr. Burford: We have stipulated that there was joint control.

The Court: Then why cross-examine him on it?

Mr. Sherman: Very well, your Honor.

Q. Was it your understanding at that time, Mr. White, that all money from the Marine Development job at Camp Pendleton was to go into the trust account?      A. That is right.

Q. Was it also your understanding that the money Mrs. Clausen was putting up would also go into the trust account?

A. That is right. [159]

Q. At the time that the bond was written, Mr. White, under the name of Wright-Ahlgren your company was performing a job for Webb & Knapp?

A. I don't think the bond was written under the name of Wright.



(Testimony of Albert C. White.)

The Court: It says your company was performing——

Mr. Sherman: Performing a job under Wright.

The Court: That assumes a fact not in evidence.

Mr. Sherman: I am asking the witness whether or not at the time the bond was written your company——

The Court: That is it, what company?

Mr. Sherman: The White-Ahlgren Company.

The Court: Yes?

Mr. Sherman: Under the name of Wright-Ahlgren was performing a job for Webb & Knapp at Claremont Gardens.

The Witness: That is right.

Q. (By Mr. Sherman): Now with the exception of a payment on December 15, 1953, from the Webb & Knapp people, to your knowledge did White-Ahlgren get paid any monies from the Webb & Knapp job after the Camp Pendleton job [160] started?

\* \* \*

The Court: He wants to know whether or not after December 15th the White-Ahlgren Company received any money from the [162] Webb & Knapp contract at Claremont Gardens?

The Witness: We didn't. The company didn't receive any money, no. There was money due, if that is what you mean.

Q. (By Mr. Sherman): But you didn't receive any?  
A. We didn't receive any, no, sir.

(Testimony of Albert C. White.)

Q. Were there any other jobs being performed by your company at the time the Camp Pendleton job was being performed from which you could have received money? A. No, sir.

Q. So then the Camp Pendleton job was the only job from which you were actually receiving money?

A. That is right, sir.

Q. And all of those monies, I believe you testified, were required to go into the joint control?

A. Into the joint control account.

Q. Was it also a requirement that all disbursements from the trust account required a counter-signature of Century Indemnity?

A. Yes, sir.

Q. Mr. White, I now show you Defendant's Exhibit V for identification, which purport to be checks on the White-Ahlgren Trust Account in blank except for your signature. Have you seen those before? A. Yes, sir. [163]

Q. Is that your signature on those blanks?

A. Yes; it is.

Q. What did you do with them after you so signed them?

A. I signed these in Mrs. Cole's office and the object of this was when bills occurred on the job and were sent to her for payment, she could use these checks to pay these bills, and with my already signing them I wouldn't have to drive up from San Diego and she wouldn't have to come back down to San Diego to sign these checks.

(Testimony of Albert C. White.)

The Court: Do you know whether she did do that on any occasion?

The Witness: I am sure she did.

Q. (By Mr. Sherman): Did you give those to her? A. Yes; I did.

Mr. Sherman: I offer them into evidence as Defendant's Exhibit V, your Honor.

The Court: Admitted.

(The documents referred to were marked as Defendant's Exhibit V and received in evidence.)

Q. (By Mr. Sherman): Now going to the time when The Century representative would come down to the job site every Friday to countersign the payroll checks, do you recall whether or not [164] payroll recaps were furnished to Mrs. Cole during those occasions when she appeared at the job site?

A. Yes, she would have the payroll recaps.

Q. And she also was furnished payroll recaps before that procedure was instituted?

A. Yes, before they started coming down to our job office to sign them. Our office mailed payroll recaps to Mrs. Cole's office.

Q. And you would also furnish Mr. Van Tassel with such payroll recaps when he would come down on the job? A. That is right.

Q. That was the manner in which they were able to check as to what was due and the amount of the check he had written to the employees, is that correct? A. That is correct.

Q. Now you testified with reference to a discus-



(Testimony of Albert C. White.)

sion you had with Mr. Van Tassel concerning payment of payroll taxes.

Was that, as best you recall, at a time when Mrs. Higgins presented to Mr. Van Tassel a check for his countersignature on the payment of such taxes?

A. I believe it was, yes.

Q. And at the same time did she submit a quarterly return to Mr. Van Tassel for his approval?

A. Now whether she submitted a quarterly return made up or not, I don't know. [165]

Q. I believe you further testified that at that time there wasn't enough money in the trust account to pay the taxes, is that correct?

A. That is right.

Q. Had you up to that time been paying suppliers? A. Yes; as far as we could.

Q. And you had been paying payroll?

A. That is right.

Q. And other items? A. That is right.

Q. And the shortage in the account was because of these items which you paid?

The Court: That calls for a conclusion of the witness.

Mr. Sherman: Very well.

The Court: The shortage in the account was because there wasn't enough money in the account?

Mr. Sherman: I am trying to determine why there wasn't enough money, your Honor.

Q. Now you also testified concerning conversations you had had with Mr. Van Tassel and Mrs. Cole concerning which suppliers to pay. In whose

(Testimony of Albert C. White.)

lap, if I may use that term, if you understand it, did the ultimate decision lie as to whether or not a particular supplier would be paid, yourself or the representative of Century Indemnity Company?

Mr. Burford: Isn't that also a conclusion, your Honor? [166]

Mr. Sherman: I think, your Honor, this goes to the question of how was the procedure carried out.

The Court: The objection will be sustained.

Q. (By Mr. Sherman): Now with respect to these checks that you testified about, which were written without the countersignature, your book-keeper, Irene Higgins, did have checkbooks of the trust account, blank checkbooks of the trust account, did she not?

The Court: You are referring now to this series of checks signed when the job was first commenced?

Mr. Sherman: I am referring to that period, your Honor.

The Court: Yes.

Q. (By Mr. Sherman): She did have blank checkbooks?           A. Yes.

Q. Checks on the trust account?

A. She had the trust account checkbook there.

Q. Were they given to her by Mrs. Cole?

A. I am going on the assumption that she did, she had them, and I am sure Mrs. Cole would probably have to give them to her.

Q. Did you give them to her?           A. No.

(Testimony of Albert C. White.)

The Court: Do you know whether she got them from Mrs. Cole or the bank? [167]

The Witness: I am sure she had picked them up from Mrs. Cole. Mrs. Cole had left the checkbook there.

Q. (By Mr. Sherman): What were the circumstances under which you first discussed the writing of these checks with Mrs. Cole, did she call you or did you call her?

A. No; I am sure that I called Mrs. Cole.

The Court: "These check"?

Mr. Sherman: Yes, your Honor.

The Court: What are "these checks"?

Mr. Sherman: You are correct, your Honor. The checks, Plaintiff's Exhibit 36, I believe, which did not contain any countersignature.

Q. You were saying?

A. I am sure I called Mrs. Cole's attention to the fact after I had noticed what we were doing, in going back over and discussing it, if my memory of the mechanics of the Trust Account No. 1 is correct, and why the checks were made that way, the more I thought about it the more I knew we were wrong, there was a mistake made, the payroll was not supposed to be made on that particular checkbook.

I called Mrs. Cole on the phone from our office in San Diego and called her attention to it, that I personally thought a mistake had been made, that the checks weren't supposed to be made on that particular check. [168]



(Testimony of Albert C. White.)

Q. Did she at that time indicate to you that she knew about it?

A. No; I believe that was Mrs. Cole's first knowledge that it was being done that way.

Q. Now with reference to the officers and employees of White-Ahlgren, and who they were to be, did Mrs. Cole select Mrs. Clausen as secretary-treasurer of the White-Ahlgren Company?

The Court: That calls for a conclusion of the witness, Counsel.

Mr. Sherman: I will rephrase it then, your Honor.

Q. Were you present at any time when Mrs. Cole stated in your presence to Mrs. Clausen, in words or substance as follows: You people need a secretary-treasurer and Mrs. Clausen might as well be it?

A. Yes, I was present. I can't swear under oath that that was the exact words, but we did someone to sign as secretary and treasurer at that time, and she turned to Mrs. Clausen then and said, "Will you sign as secretary and treasurer?"

Q. Did you ever have a discussion with Mr. Waite concerning the hiring of Mrs. Hoover as the auditor for White-Ahlgren?

A. Not to my knowledge. I don't remember talking to Mr. Waite about Mr. Hoover. [169]

Q. Did you ever discuss it with Mrs. Cole?

A. No.

Q. Did she suggest that White-Ahlgren hire Mr. Hoover?

(Testimony of Albert C. White.)

A. Mrs. Cole discussed Mr. Hoover with me one time. She started by saying we needed a good auditor, which was true, we did one, and she recommended Mr. Hoover.

Now, how Mr. Hoover got hired by our organization, I can't truthfully answer you that question because I didn't hire him.

Q. Did Mr. Hoover come upon the scene after the Marine Development people had brought you in for discussion pertaining to the rate of progress you were making on the job?

Mr. Burford: If the Court please, I don't particularly object to this but——

The Court: That is far afield from the direct examination. Objection sustained.

Mr. Sherman: May I, for the purpose of that question and some others, adopt this witness as my own, your Honor?

The Court: Better make up your mind. Let us not flop around. If you are through with cross-examination and want to call him on direct, you can now call him as your direct witness.

Mr. Sherman: I will continue with the cross-examination and then pick up with such other questions as the Court feels I have no right to ask him now on cross. [170]

The Court: Very well.

Q. (By Mr. Sherman): Now you testified, Mr. White, concerning the manner under which John Ray left the employ of the White-Ahlgren Company, and I believe you stated that the Marine De-

(Testimony of Albert C. White.)

velopment people called Mr. Van Tassel as well as yourself into their office to discuss this matter.

A. Yes. I am not sure exactly how we were called in. I know it was pertaining to, I presume this letter of Mr. Oakes, or something similar to it, concerning the work. I don't remember whether they called Mr. Van Tassel and myself for a meeting specifically for that, or if we were in on some other discussion, but this came up. I am sure Mr. Van Tassel was asked to be in the meeting the same as I was.

Q. In discussing the matter with you, did they all talk directly to Mr. Van Tassel or was all the conversation directed to you?

Mr. Burford: I will object to that, your Honor.

Mr. Sherman: This is cross-examination of a matter brought up on direct, your Honor.

The Court: It calls for his conclusion whether the conversation was directed to him.

The Witness: I would answer this, I think it was directed to both of us from time to time. [171]

Q. (By Mr. Sherman): Well, after you left that meeting, Mr. White, did you then see Mr. Ray?

A. Yes, we did. Mr. Ray and Mr. Ahlgren were waiting for us outside, and after this particular ultimatum, shall we say, was given to us by the Marine Development officials, I believe we asked them—I think Mr. Van Tassel asked them—for a short recess so we could go out and discuss it with Mr. Ray and Mr. Ahlgren.

When we went out Mr. Van Tassel discussed their



(Testimony of Albert C. White.)

ultimatum with them and under what conditions they would go along with.

Q. Who was it who told Mr. Ray that he would have to leave?

A. Well, I think Mr. Van Tassel explained it to both Mr. Ray and Mr. Ahlgren.

Q. Well, Mr. Ray at that time was working for White-Ahlgren, was he not? A. Yes, he was.

Q. And after he was advised of how Marine Development felt about his continuance of services, who was it who told him that under the circumstances, or whatever the conversation may be, but who was it that eventually told him, you will have to leave?

A. Well, I will answer it this way: I think Mr. Van Tassel because that was the understanding of the conditions that [172] Marine Development gave us, that we would have to go along with.

Q. Did you tell him he would have to leave?

A. I don't recall telling him personally he would have to leave, no, sir.

Q. Did Mr. Ahlgren tell him?

A. I am not sure that I heard a discussion between Mr. Ahlgren and Mr. Ray.

The Court: When did he leave, right at that instant?

The Witness: He left, I think, that day, or he left the following morning.

Mr. Sherman: Now, with the Court's permission, if I may, I would like to ask this witness some questions on direct examination.

(Testimony of Albert C. White.)

The Court: Very well. You will call him on direct.

ALBERT C. WHITE

called as a witness by and on behalf of the defendant, having been previously duly sworn, was examined and testified as follows:

Direct Examination

By Mr. Sherman:

Q. About when did Mr. Robert Easton come to work for White-Ahlgren Company? [173]

A. Mr. Easton came down, I believe, either the latter part of March or the first of April, if my memory serves me correct.

The Court: Who was Easton now?

The Witness: He was field bookkeeper or job bookkeeper up on the job, or cost account man.

Q. (By Mr. Sherman): When did he come on the job in relation to Mr. Hoover?

A. I believe he came after Mr. Hoover.

Q. Do you know the circumstances under which Mr. Easton was hired by White-Ahlgren?

A. No, I don't. I believe Mr. Hoover was instrumental in bringing Mr. Easton into the office. The particulars of it I am not familiar with.

Q. Now during the time that Mrs. Cole was acting as trustee of the joint control account, did you have any discussions with her concerning the daily progress of the job? A. Yes, I did.

Q. What would you discuss in such discussions?

(Testimony of Albert C. White.)

A. In discussing the daily progress of the job with Mrs. Cole, it was how many yards of concrete had been placed, how many units had been poured, or finished, as far as the concrete work was concerned.

Q. Did you discuss with her the number of men used on [174] the job?

A. I believe a time or two we did, yes, sir.

Q. Now you are familiar, I believe, with the letter of March 23rd which Mr. Oakes wrote, the letter concerning White-Ahlgren falling behind on the job?

A. Yes, sir.

Q. Would you please explain to the Court what brought that about, what the difficulty was?

A. The difficulty that necessitated Mr. Oakes writing that letter is a question that is debatable in this respect, I would say between a developer and a subcontractor. They felt that we weren't pouring as many units as we actually should pour per day. They felt that we were falling behind on our contract and that we were on the verge of default.

Q. Did you ever make a determination that the job had been underbid?

A. Had we ever made a determination?

Q. Did you ever make a determination that the job had been underbid?

A. Oh, yes, sir.

Q. When was that determination made?

A. Along about the middle of February, I believe.

Q. What was the nature of the determination?



(Testimony of Albert C. White.)

I mean, what took place that led you to the conclusion that that job had been underbid? [175]

A. All the garage elements that went with these units, they were 10-car garages——

The Court: 10-car?

The Witness: 10-car garages, yes, sir.

On the plans that were sent in here to the Weeks Engineering Company, Inc., who handled all the estimating, material estimating, it showed that the garages and driveways to the garages were to be in asphalt construction, but the set of plans that we were given by Marine Development to build the job by showed the driveways and the garage slabs in concrete, which meant that we poured 2,100 yards of concrete, plus the labor, plus the extra materials that went with it, for which we did not draw any money for.

The Court: You mean for each unit or for the total job?

The Witness: The total job, sir. I believe our estimates showed we had poured in addition 2,100 yards of concrete that we did not draw money for.

Q. (By Mr. Sherman): So if you stuck to your original contract price you would come out short?

A. That we would have come out short?

Q. Yes.

A. That I couldn't answer you truthfully.

The Court: You did come out short? [176]

The Witness: Yes, we did, very short.

Q. (By Mr. Sherman): Did you communicate

(Testimony of Albert C. White.)

to any representative of Century Indemnity your determination in this regard?

A. I don't believe I follow you, Mr. Sherman.

Q. Did you tell anybody who was acting for Century Indemnity Company about this?

A. About this shortage?

Q. Yes, sir.

A. Oh, yes. We notified Mrs. Cole immediately upon determining that we were short.

Q. Then this Oakes letter thing broke, is that correct?

A. Well, that came after our determination that we were short on the bid, yes.

Q. It was after all of that had taken place that signing individual payrolls at the job site commenced?

A. No. The part of signing the checks on the job site came shortly, as a matter of fact, the next payroll period, the next weekly period after these checks here were started, which necessitated Mrs. Cole——

Q. These checks were in January.

A. Well, then, if my memory serves me correct, she came down then for the very next payroll period, I am sure, and started the countersigning on the job site.

Q. Does it refresh your recollection at all as to whether [177] or not before she did that she paid net instead of gross and then started countersigning at the job site, does that refresh your recollection at all?

(Testimony of Albert C. White.)

A. I don't remember whether or not we drew on the net or the gross side from the very beginning. I am not sure. I don't remember.

Q. It was after all that happened that Mr. Van Tassel first appeared on the job, is that correct?

A. Yes; that is true.

Mr. Sherman: May we have this assignment dated May 28, 1954, marked Plaintiff's Exhibit 27 for identification?

The Court: Is that the same number it has in the pretrial order?

Mr. Sherman: That is correct, your Honor.

The Court: It will be so marked.

(The document referred to was marked as Plaintiff's Exhibit No. 27 for identification.)

The Court: I think it is in evidence.

Mr. Sherman: No, it is not, your Honor.

Q. Mr. White, I hand you that which has been marked Plaintiff's Exhibit 27 for identification and I ask you if you recognize that?

A. Yes; I recognize it.

Q. Would you please tell the Court what that is? [178]

A. This job was the Crevette Construction Company, we always referred to it as the Webb & Knapp job; I knew they had another name but it slipped my mind, so it is Crevette when we speak of Webb & Knapp.

Prior to my going into the organization down there they had a contract with Crevette Construc-



(Testimony of Albert C. White.)

tion Company and it was near completion when I came on the scene.

They had a system of holding back a 10% retention clause, and then when the Webb & Knapp job was completed, or shall we say as near completion as we can get to be able to draw some of this money, we had certain monies coming under the 10% retention clause for which we signed over our rights to The Century Indemnity Company to go into their funds to supplement anything perhaps they had paid out.

Q. That is an assignment of White-Ahlgren's rights to receive any further payment?

A. That is right.

Q. Did that assignment take place after Century's representatives were informed about the underbidding?

A. Yes, it was. This is dated August 19th. It would have to be after that date.

Q. May or August?

A. This says here on or about August [179] 19th.

\* \* \*

Q. Did you have a conversation with Mr. Van Tassel in which he told you that whatever income from any source White-Ahlgren was going to get they would have to transfer it over to Century?

A. I had a discussion with Mr. Van Tassel and Mr. Waite both along those lines after we realized that we were going to have to draw on Century

(Testimony of Albert C. White.)

Indemnity to pay the bills. I think they both pointed out to me at that time that whatever income, whatever profits or whatever source of revenue or collateral we had naturally would have to go to them in payment for what we had drawn on.

The Court: Did Century Indemnity advance money to complete the job?

The Witness: Yes, sir; they did.

The Court: How much?

The Witness: I am not sure of the amount, sir.

Mr. Burford: That is stipulated to, your [183] Honor.

The Court: It is a thousand dollars?

Mr. Burford: It was \$119,000. The thousand dollars was the amount that was paid to complete the last payroll.

Mr. Sherman: They paid, I think, materialmen's bills and then the last payroll.

Q. Did you ever promise Mr. Van Tassel or any other member of Century Indemnity Company that you, meaning White-Ahlgren, would pay the Federal taxes?

A. No, I don't ever recall making that statement.

Q. Did you ever tell Mr. Van Tassel or any member of The Century Indemnity Company that you were going to get extra money from Marine Development for these cement slabs that you laid and would pay the taxes from that?

A. No, sir, I never told them we were going to get any money, although we had discussed it a

(Testimony of Albert C. White.)

lot of times as a mere hope that it might be possible, but we never made any promises with that in mind, that we knew we were going to draw that money.

Q. Was Mr. Van Tassel present in these conversations concerning this hope?

A. Yes, he was. Mr. Van Tassel was present with myself in a meeting with Mr. Fritz Hahn and their attorney at one time concerning these slabs.

Mr. Sherman: No further questions, your [184] Honor.

\* \* \*

### Cross-Examination

By Mr. Burford:

Q. Mr. White, my cross-examination will be quite brief at this point.

I want to direct your attention to the question of the discharge of Mr. Ray.

Now as I understand what you testified to, there was a meeting with Marine Development where Marine Development insisted that Mr. Ray be supplanted by another man who would be directly accountable to Marine Development.

A. That is right.

Mr. Sherman: I will object to this question on the ground that this is something that was raised on direct, this is not something that we raised on our direct of this witness. This is presumably cross-examination of the matters raised on direct.



(Testimony of Albert C. White.)

If the government is to be held to a strict line on that I believe it is only proper to hold plaintiff to such a line, too. He is merely re-going over matters he raised on direct.

The Court: He hasn't asked a question yet. He is just reciting his understanding of what the witness testified to.

Mr. Sherman: But that is pertaining to the topic that he raised.

The Court: Maybe his question will relate to some new [185] matter.

Mr. Sherman: Very well.

Mr. Burford: Well, your Honor, it does relate to the clarification of the statement of the witness with respect to who told Mr. Ray that he would leave.

Mr. Sherman: Then my objection stands.

The Court: The objection is overruled. Ask your question.

Q. (By Mr. Burford): Mr. White, when Mr. Van Tassel came out of the Marine Development office you testified that he discussed this ultimatum of Marine Development with Mr. Ahlgren and Mr. Ray was present, is that correct?

A. That is right.

Q. Was any conclusion reached in connection with that discussion?

Mr. Sherman: I will object to the form of the question, your Honor.

The Court: It calls for a conclusion.

(Testimony of Albert C. White.)

Q. (By Mr. Burford): What was the result of that discussion?

A. Well, the result of the discussion was the fact that Mr. Ray would no longer be there and Mr. Jones, I guess his name is, would have to take his place.

The Court: Did Mr. Jones take his place the next day? [186]

The Witness: I believe it was the very next morning Mr. Jones was brought in.

Q. (By Mr. Burford): To your knowledge did Mr. Van Tassel have any right to hire or fire employees of White-Ahlgren?

Mr. Sherman: Now I will object to that, your Honor. It calls for a conclusion of this witness. We have had testimony as to what was done. Now this question is saying did he have the right to do what he did. I don't believe that is proper.

Mr. Burford: We have testimony, your Honor, as to what happened, but we haven't quite cleared up what was done, as I understand it.

The Court: Your question here is whether or not this witness has any knowledge of whether or not Mr. Van Tassel had the right.

Mr. Burford: Yes.

The Court: Overruled.

Do you know whether or not he had the right?

The Witness: Whether Mr. Van Tassel had the right to hire or fire?

The Court: To hire or fire any person.

(Testimony of Albert C. White.)

The Witness: No, Mr. Van Tassel didn't have the right to hire and fire. [187]

Q. (By Mr. Burford): Did Mr. Ahlgren, to your knowledge, have the right?

A. Yes, Mr. Ahlgren had the right.

Q. And he was present at that time?

A. Yes, that is right.

Mr. Burford: May I have a brief moment, your Honor?

(Conference between counsel.)

Mr. Burford: No further questions, your Honor.

Mr. Sherman: No further questions.

The Court: This witness is excused. [188]

\* \* \*

### BURTON A. VAN TASSEL

a witness called by and on behalf of the plaintiff, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name in full, please.

The Witness: Burton A. Van Tassel; V-a-n T-a-s-s-e-l.

The Clerk: Your address, please, business.

The Witness: 900 Wilshire Boulevard.

The Court: And your first name?

The Witness: Burton, B-u-r-t-o-n. [192]

### Direct Examination

By Mr. Burford:

Q. Mr. Van Tassel, you are an attorney here in Los Angeles?      A. I am.



(Testimony of Burton A. Van Tassel.)

Q. Are you a member of a firm? A. Yes.

Q. What is that?

A. Nicholas, Kolliner & Van Tassel.

Q. Mr. Van Tassel, directing your attention to the end of 1953 and during 1954, was The Century Indemnity Company at that time one of your clients? A. Yes.

Q. You are familiar, of course, with the contract here in issue between Marine Development and White-Ahlgren? A. I am.

Q. Will you state for the Court approximately when that contract and the surety bond between the subcontractor and Century Indemnity first came to your attention?

A. About March 30, 1954.

Q. Under what circumstances did this come to your attention?

A. On that date, as I recall, Eva Cole, Mr. D. J. Waite and Albert C. White came to my office——

Q. Why did they come? [193]

Mr. Sherman: I will object to that, your Honor. That calls for a conclusion of this witness.

The Court: Objection sustained.

Q. (By Mr. Burford): What happened when they came?

A. They showed to me a letter that was written——

The Court: Who was this that came to you now?

The Witness: That was Eva Cole, D. J. Waite and Albert C. White.

The Court: Now let me get again in my mind,

(Testimony of Burton A. Van Tassel.)

I was making some catch-up notes, your relationship to this matter. You are a lawyer?

The Witness: I am a lawyer.

The Court: You are counsel for whom?

The Witness: For The Century Indemnity Company, the plaintiff here.

The Court: For The Century Indemnity Company?

The Witness: Yes.

The Court: Very well.

The Witness: At the time they arrived they showed to me a letter addressed to Eva Cole written by Robert Oakes, an attorney in San Diego.

Q. (By Mr. Burford): Mr. Van Tassel, I show you Plaintiff's Exhibit 10, on the letterhead of Oakes & Horton. Is this the letter to [194] which you refer? A. It is.

Q. What discussion took place at that conference?

A. Well, at that time they informed me that the meeting referred to in the letter had taken place, that Mr. Oakes as attorney for Marine Development had issued the letter and had sent the letter and was asking that The Century Indemnity Company execute it in the space provided, which would have completed the signatures of all of the parties referred to in the letter.

Q. Did you discuss with any of these participants at that conference the reason for the letter?

A. Yes. The rate of progress, it was claimed by Marine Development Company—

(Testimony of Burton A. Van Tassel.)

The Court: Have you got that letter there?

The Witness: Yes, I have it.

(The exhibit referred to was passed to the Court.)

The Court: Do you need it?

The Witness: No, I don't.

The rate of progress of the work, according to Marine Development, had been slowed down and they were complaining about that and were submitting a reduced schedule or modified schedule together with a proposed program of paying a payroll of White-Ahlgren as the work progressed by the week instead of [195] by the month.

Do you want me to proceed?

Q. (By Mr. Burford): When you say "payroll," you mean progress payment of Marine Development to be accelerated to weekly rather than monthly, is that what you mean?

A. That is what I mean, yes.

Q. After this conference what action did you take then?

A. I promptly got in touch with The Century Indemnity Company——

The Court: Did you execute the letter?

The Witness: No.

The Court: It never was executed?

The Witness: It never was executed.

The Court: By you or Century Indemnity?

The Witness: That is correct.

Q. (By Mr. Burford): Perhaps, Mr. Van Tas-



(Testimony of Burton A. Van Tassel.)

sel, you would like to explain for the benefit of the Court at this time why the letter was never executed.

A. I would, with the Court's permission.

The Court: It calls for his conclusion. Very well, you may.

The Witness: Following—I am trying to give this in a brief, chronological outline of what occurred—following the [196] meeting, aside from getting in touch with The Century Indemnity Company and being notified by them that they could give no immediate answer on this, because this bond was reinsured and they would have to get in touch with their reinsurers, I had communication back and forth, both verbally and by letter, with Mr. Oakes, attorney for the Marine Development Company, and then, as I recall on April 9th, I went down to Camp Pendleton for the first time and met White and Ahlgren, and from there went on down to San Diego by appointment to meet with Mr. Oakes.

At that time in discussing the matter with him I pointed out the different stages of work which had to be performed, some 12 in number, as I recall, separate operations, your Honor, and from the report made to me by Mr. White and Mr. Ahlgren the work was sufficiently in advance of the next trade—I believe they were the carpenters or plumbers—so that there was, in fact, no real slowdown as far as Marine Development was concerned.

While I was there Mr. Oakes received a telephone call from Mr. Summers of Marine Development at

(Testimony of Burton A. Van Tassel.)

Camp Pendleton and then informed me following that phone call that Mr. Summers agreed that there was no emergency in this situation, that he was pleased with the progress that had been made and that there was no insistence on the part of Mr. Summers that the letter provided here as the Plaintiff's exhibit be executed by The [197] Century Indemnity Company, and it never was executed by them.

Q. (By Mr. Burford): Did the arrangement with respect to the schedule of work and progress payments insofar as you know, as outlined in that letter, remain in effect?

A. Yes. They continued to make the payments, the progress payments, on a weekly basis rather than on a monthly basis.

Q. Following that conference, I believe you said it was April 9th——

A. That is my recollection.

Q. ——did you become one of the authorized signators to sign as trustee for Century Indemnity?

A. I did.

Q. That would be as set forth in Exhibit 4-C of the plaintiff.

Thereafter, Mr. Van Tassel——

The Court: Let me see, that was on what date now?

(The exhibit referred to was passed to the Court.)

The Court: Well, as near as I can read this the date is April 19, 1954.

(Testimony of Burton A. Van Tassel.)

Mr. Burford: That is our understanding, your Honor, that on or about that date Mr. Van Tassel became one of the authorized signators to sign as trustee on behalf of Century [198] Indemnity.

The Court: Go ahead.

Q. (By Mr. Burford): Now, Mr. Van Tassel, following this conference of April 9th and your having to become an authorized signator on this White-Ahlgren trust account, what was your method of operation with respect to White-Ahlgren and the signing of checks?

A. The payroll checks were signed on Friday of each week, and generally I came down, I went down to Camp Pendleton on Friday morning and arrived there normally in the mid-morning, and inquired as to what problems they might have to discuss and if the estimate had been prepared for the work done for the past week, and then the payroll recap, a copy of it, was furnished to me by Mrs. Higgins, the bookkeeper, the payroll checks had all been prepared as listed on this payroll recap, and it was my practice to check on the name, in other words, examine the name of each individual worker, employee, of White-Ahlgren, to be certain that the list and the check, the payee of the check, corresponded and that the net amount of the check as shown on the recap list and on the check corresponded, and having done so one by one I would check them off as I went down the list and would countersign the checks.



(Testimony of Burton A. Van Tassel.)

Q. What did you do with the checks after you countersigned them? [199]

A. I don't recall that I did anything with them. It was a matter of Mr. White or Mr. Ahlgren taking the checks then and either personally delivering them or handing them to one of the foremen.

The Court: You just left the checks there?

The Witness: I just left the checks there.

Q. (By Mr. Burford): Now, Mr. Van Tassel, did you countersign any checks for any purposes other than for payroll? A. Yes.

Q. What sort of checks were those?

A. Those would be checks on account of material bills incurred.

Q. How did you determine which checks for material bills to countersign?

A. That was by mutual understanding between White and Ahlgren and myself as to which bills should be paid. There never was enough money to pay on all the outstanding bills.

The Court: How do you mean, what process did you take? Were there invoices there?

The Witness: There were invoices.

The Court: Did you check to see whether or not the material was delivered under the invoices?

The Witness: No, I had to take their word.

The Court: You accepted their word? [200]

The Witness: To the effect that it was a proper bill. But there were some bills, your Honor, such as repair bills on equipment, where we didn't expect to have to use it.

(Testimony of Burton A. Van Tassel.)

The Court: Then you took the bills and sorted them out and put in the bills you would pay now, next week and wait?

The Witness: In a general sense that was the way we handled it. There wasn't enough money to pay them all and it was a case of choosing bills which we felt we would necessarily have to make some payment on in order to keep the credit good because there would have to be some more material ordered, and White and Ahlgren are more familiar with that than I, and we simply discussed it and determined by mutual agreement which ones should have the payment made on account.

The Court: Whose decision in that was the final decision? Did you accept their recommendation or did you override their recommendation as to which bills should be paid or delayed?

The Witness: I would concur with their suggestion in that regard because they were the ones who were familiar with the payment of which bills were necessary in order to keep the job going.

The Court: Did you ever make a suggestion to them that such and such a bill should be paid as against another bill?

The Witness: Oh, I think I perhaps did on occasion.

The Court: And did they accept it?

The Witness: Yes. [201]

Q. (By Mr. Burford): Who would be your main material suppliers on this job, Mr. Van Tassel, not necessarily the name but the type of material?

(Testimony of Burton A. Van Tassel.)

A. The principal material supplier was Neslo Corporation, which supplied the mixed concrete. Their bill was always the largest.

Then there was the Rohl Company, who supplied crushed rock.

Aside from those there were bills for a particular type of paper required in pouring the building slabs and there was reinforcing steel, lumber for the concrete forms.

Those were the general ones which I recall.

Q. How were these bills ordinarily, let's say, by the two largest suppliers, Neslo and Rohl, daily, monthly, weekly, or what?      A. Monthly.

Q. They were billed monthly?      A. Yes.

Q. Did you ever have any discussion with either Neslo or Rohl about the payment of their bills during this period?

A. You mean during the period of the job?

Q. Yes, during the period of the job.

A. Yes, I did.

Q. What sort of discussion did you have with them? [202]

A. At one juncture, as I recall, it was along in May of that year, it could have been later, we didn't have enough money to pay their mixed concrete—I am talking about Neslo now——

The Court: Who is "we," Century?

The Witness: When I say "we," there was not enough money in the trust account so that had a check been issued against it for the full amount



(Testimony of Burton A. Van Tassel.)

of the material bill then due it wouldn't have cleared.

So I do recall making the request that they bear with us if we made a payment on account at that time and endeavored to pay the balance in the following week or possibly the week after that.

I had other contacts with them, as far as that is concerned, if you wish me to proceed.

Mr. Burford: Not unless his Honor would like to explore this phase of it.

The Court: No.

Q. (By Mr. Burford): Now, Mr. Van Tassel, did you ever refuse to sign any checks that were presented to you for countersignature?

A. Yes, I did.

Q. Would you give an example of that? Were there several instances?

A. I don't recall several instances. I recall one in [203] particular.

Q. What would that be?

A. That would be, as I recall, on April 30th when the payroll taxes for the first quarter of 1954 were due and payable.

Q. Will you just state the circumstances surrounding that incident?

A. Yes. At that time, as I recall, the payroll tax return had been prepared by Mrs. Higgins and had been signed and, if I recall it correctly, the amount was some \$11,000.

Q. Signed by whom?

(Testimony of Burton A. Van Tassel.)

A. I don't recall, Mr. Burford, whether the check was already signed by anyone.

Q. I thought you said signed.

A. Well, I was trying to say that the payroll tax return was, if I recall correctly, already signed.

Q. Excuse me.

A. But I believe the check had been prepared at that time payable to the District Director of Internal Revenue for the amount of the taxes, Federal taxes shown on the payroll tax return.

But after we had written out checks for the payroll ending that week, to the best of my recollection, and some few minor material bills, because there wasn't very much of a draw at that time, there remained in the account, to the best of my [204] recollection, somewhere in the neighborhood of \$3,000 plus, which wouldn't have covered a tax check for roughly \$11,000.

Q. Where did this discussion take place?

A. That would have been in the field headquarters of White-Ahlgren, which was a little office shack, you might call it.

The Court: A construction shack?

The Witness: A construction shack on the job.

Q. (By Mr. Burford): Do you recall who was present at that time?

A. I believe that Mr. White and Mr. Ahlgren and Mrs. Higgins were present.

Q. So you did refuse to sign this check?

A. I did.

(Testimony of Burton A. Van Tassel.)

Q. Because, as you testified, there were insufficient funds in the account?

A. That is right.

Q. For it to clear? A. That is right.

Q. What action did you recommend, if any?

A. That they mail in the tax return even though it could not be accompanied by the check.

Q. Do you know whether that was done?

A. I do not. I had no personal knowledge of it. I believe it was done. [205]

Q. Mr. Van Tassel, in connection with the payment of these payroll checks, did you initiate that procedure?

A. Are you talking about the countersigning of the individual payroll checks?

Q. Yes.

A. No. I simply carried along on the procedure already in full force and effect at the time I came into the picture.

Q. Now, Mr. Van Tassel, the construction shack of White-Ahlgren was on the project. Where was the Marine Development construction shack in relation to the White-Ahlgren shack?

A. Well, it was on the tract. It was the same general tract, as far as that is concerned, perhaps three-quarters of a mile apart.

Q. When you were in Camp Pendleton on these Fridays, would you have occasion from time to time to confer with representatives of Marine Development?

A. Not to any great extent. I had made it a



(Testimony of Burton A. Van Tassel.)  
practice of accompanying Mr. White and Mr. Ahlgren to the Marine Development Company construction shack headquarters.

Q. Directing your attention to on or about July 2nd of 1954, did you have a conference with Marine Development representatives on or about that day?      A. I did.

Q. Will you state to the best of your recollection who [206] was present?      A. Yes.

The Court: What date is this again now, please?

The Witness: That is July 2, 1954.

The Court: Proceed.

The Witness: Mr. Hahn, Mr. Neece, Mr. Summers and Mr. Jackson, together with their attorney, Robert Oakes, and Mr. Albert C. White.

The Court: Who was Hahn and Neece and Summers and Jackson, Marine Development people?

The Witness: They were the Marine Development Company, your Honor. They are the four principals in that company.

The Court: Then there was present Mr. Ahlgren or Mr. White?

The Witness: Mr. White.

The Court: Mr. White and yourself?

The Witness: And myself.

The meeting took place in a then permanent building which was built for rental purposes to handle the rent to the people who were going to occupy these units being built, so it was then in a permanent building.

(Testimony of Burton A. Van Tassel.)

Q. (By Mr. Burford): Where was Mr. Ahlgren, if you know?

A. Mr. Ahlgren remained outside talking to Mr. Ray, as I recall. [207]

Q. Do you know why he remained outside?

Mr. Sherman: I will object to that, your Honor. That certainly calls for a conclusion of the witness.

Mr. Burford: I will withdraw the question.

Q. How large was this room, Mr. Van Tassel?

A. The room rather uncomfortably accommodated the seven people I have named.

Q. What was the subject of this conference?

A. There were two or three different things that were covered. One, the Marine Development Company through Mr. Hahn as spokesman—I understood he was the present—stated that in the last week or two there had been quite a number of complaints by the inspectors, government inspectors on the job, and that it had reached the point where it was critical and that they were, in substance, notifying Century through me and White-Ahlgren through Mr. White that as an alternative to the declaring of a default on the part of White-Ahlgren they would allow them to continue the work on the subcontract, providing a man named, I believe his first name was Richard, Jones was rehired by White-Ahlgren and made directly accountable to Marine Development's job superintendent Frank Jackson.

Q. What was the result of this, shall we say, ultimatum?

(Testimony of Burton A. Van Tassel.)

A. Mr. White and I went out and discussed the matter with Mr. Ahlgren and Mr. Ray, as I recall, and explained to them [208] that that was the alternative offered, and we concurred that there was nothing else to be done in the matter.

Q. When you say "we," you mean——

A. I mean to say Mr. White, Mr. Ahlgren and I felt that rather than have a default declared by Marine Development that the proper thing to do would be to rehire Mr. Jones.

Q. And he was rehired?

A. He was rehired.

The Court: Did he thereafter run the job and account to Mr. Richards of Marine Development, if you know?

The Witness: Mr. Jackson you mean?

The Court: Jackson, yes.

The Witness: Yes.

The Court: Did you follow the practice after that of going down every week and signing payroll checks?

The Witness: Oh, yes.

The Court: Did you talk to Jackson or White and Ahlgren?

The Witness: I talked to White and Ahlgren.

The Court: Had they talked to Jackson?

The Witness: No. I mean they didn't have any occasion to under the arrangement.

The Court: As far as you know, they didn't?

The Witness: That is right. To my knowledge this was simply a matter of supervision, the chain



(Testimony of Burton A. Van Tassel.)

of command, so to speak, so far as the performance of the work on the job was [209] concerned, but with respect to payment of bills, material bills and payment of the payroll, there was no outward change.

The Court: I see.

Q. (By Mr. Burford): Mr. Van Tassel, did you ever have any authority to hire or fire the persons whose payroll checks you were countersigning?

Mr. Sherman: I will object to that, your Honor. It certainly calls for a conclusion of this witness, and the very conduct testified to by the witness speaks for whether or not the witness had authority without his conclusion otherwise whether he did or not.

The Court: I think the objection will be sustained. You can ask him whether or not he ever did hire or fire anybody.

Q. (By Mr. Burford): Did you ever hire or fire any employees whose payroll check you were countersigning? A. No.

The Court: Did you ever know any of them?

The Witness: No.

Q. (By Mr. Burford): Did you have anything to do with fixing——

A. I beg your pardon. To clarify the answer, your Honor, there were a few of the people, such as Mr. White, Mr. Ahlgren, Mrs. Clausen, Johnnie Ray, who was a foreman, and one [210] or two others that I knew by sight and name, but in the

(Testimony of Burton A. Van Tassel.)

main they were workers, many of them Mexicans, and I wouldn't have known one from the other.

Q. (By Mr. Burford): Did you ever have anything to do with fixing their rates of pay?

A. I did not.

Q. Their hours of work? A. I did not.

Q. The method of their operations?

A. I did not.

Q. Did you ever supervise any of these employees? A. I did not.

Q. Mr. Van Tassel, to your knowledge, did White-Ahlgren complete the subcontract here in question? A. Yes.

The Court: When?

The Witness: About September 20, 1954.

The Court: There is another signature card here dated, following this one of April 19th, and on the April 19th card it says, "Superseded by a new card June 15, 1954," and here is a card that says "June 15, 1954, substituted," and this is Exhibit No. 4-D, and it appears to bear your signature.

Can you tell the occasion or the circumstances of that signature card, how it happened? It is on the same [211] account, is it not, the White-Ahlgren Trust Account No. 1?

Mr. Burford: Do you have Exhibit 4-C there, your Honor?

(The document referred to was passed to Counsel.)

Mr. Burford: I think there was a change of trustees.

(Testimony of Burton A. Van Tassel.)

If your Honor please, I believe that there was a change in the trustees. We agree to stipulate, however, that a representative of The Century Indemnity Company at all times here material was required as a co-signator.

The Court: Yes, but I thought there might be some circumstances which occurred in June.

The Witness: I believe I can explain that, your Honor.

The Court: Yes?

The Witness: Upon examination of these two cards I notice that the same signators appear thereon except that the April 19th card shows the name of Robert H. Easton as one of the named trustees and his countersignature appears thereon.

The Court: He is omitted——

The Witness: He is omitted on the second one.

The Court: ——on the June card?

The Witness: That is right.

Q. (By Mr. Burford): Mr. Van Tassel, do you know who Mr. Easton was?

A. Yes, he was a man whom I understood was performing the duties of a cost accountant and worked in the White-Ahlgren [212] construction shack for White-Ahlgren.

Q. Do you know why he was placed on the signature card as an authorized co-signator?

Mr. Sherman: I will object to that. That is certainly calling for a conclusion of this witness, your Honor.



(Testimony of Burton A. Van Tassel.)

The Court: Were there any conversations with anybody?

Mr. Sherman: Pardon me?

The Court: I think that that calls for a conclusion but I will overrule the objection.

Mr. Sherman: I think a foundation should be laid first, your Honor.

The Witness: May I answer?

The Court: Yes, you may answer.

The Witness: To the best of my recollection that was ahead of our opening up the so-called termination account by mutual agreement between White and Ahlgren and Century.

The Court: What is a termination agreement?

The Witness: The termination account, your Honor. An account was opened up at the Carlsbad branch of the same bank, the Security Trust & Savings Bank, which could be used for the payment of wages to employees who either quit or were fired during the mid-week and, to the best of my recollection at this point, that was the occasion for having Easton's name on as trustee for Century because we felt that there should be somebody there ahead of opening up that termination account [213] to countersign checks when they wanted to pay off.

The Court: Was he your agent?

The Witness: Well, he acted as our agent at that time temporarily.

Q. (By Mr. Burford): For that purpose?

A. For that purpose.

Mr. Burford: No further questions.

(Testimony of Burton A. Van Tassel.)

Cross-Examination

By Mr. Sherman:

Q. It is true, is it not, sir, that at all times in all of your dealings with the White-Ahlgren company and in all of your dealings with the Marine Development Company that you were acting on behalf of The Century Indemnity Company?

A. Yes, I think that is a fair statement.

Q. In your dealings with the Marine Development Company——

A. I beg your pardon. I wish to make one clarification, if I may.

Q. Very well.

A. At the time of the July 2nd meeting—and this is an error on my part, your Honor—in response to the direct examination regarding the July 2nd meeting with Hahn, Neece, Summers, et al., at the time of that meeting there was a discussion with respect to an allowance to White-Ahlgren on [214] account of putting in garage slabs which they said they had not been paid for, and in the sense that White-Ahlgren had no attorney representing them and that Marine Development had Mr. Oakes there representing them, I believe it is proper to say that I was representing White-Ahlgren in part at that time.

The Court: In the capacity of counsel?

The Witness: In the capacity of counsel, yes.

The Court: In relation to that matter?

(Testimony of Burton A. Van Tassel.)

The Witness: In relation to that matter.

Q. (By Mr. Sherman): Now at that time, at the time of that July 2nd meeting at which garage slabs were discussed, was there a difference of opinion between the White-Ahlgren people and the Marine Development people as to how much was due White-Ahlgren on the job and what kind of slabs they were supposed to pour?

A. I don't recall any difference—well, yes. When you say the kind of slabs.

There had been a contention on the part of White-Ahlgren in the very inception, in my acquaintance with this matter, that they had bid, had submitted their bid to Marine Development for this concrete subcontract predicated upon asphalt garage slabs rather than concrete garage slabs; that after the estimate had been made and the bid submitted that the blueprints had to be returned to the 11th Naval District in San Diego, and they were not able, they informed me—they [215] meaning White-Ahlgren—they were not able to trace down the location of these original blueprints, but in any event the ones that Marine Development presented to them for their work on the project did not contain the same blueprints and did provide that they must be concrete slabs rather than asphalt slabs for the garages.

Q. Concrete slabs would be installed at a higher cost than the asphalt?

A. That is my understanding, that they would be, yes.



(Testimony of Burton A. Van Tassel.)

Q. You were informed about this at the time that, shall we say, you came into the picture in this matter? A. That is correct.

The Court: In March?

The Witness: In March.

Q. (By Mr. Sherman): At that time were you also made aware of the fact that if they had to pour concrete instead of asphalt the cost would be such as to result in an underbidding of the job and they would come out with a loss rather than a profit?

A. At which time are you referring to?

Q. At the time that you were informed about this difference between Ahlgren's view as to what they had to pour and Marine Development's view.

A. Do you mean in July now or March?

Q. In March, shall we say. [216]

A. In March I was not so informed.

Q. When did you first learn that the pouring of concrete instead of asphalt slabs would result in an underbidding and consequent loss on the subcontract?

A. It might have been a month later. I can't recall that precisely.

Q. Somewhere around the period of April?

A. It could have been.

Q. At least definitely prior to this July 2nd meeting? A. Yes.

Q. Now in this discussion with Marine Development concerning these garage slabs, in which you say you acted for White-Ahlgren, did you attempt

(Testimony of Burton A. Van Tassel.)

at that time to get Marine Development to agree to additional payments on the subcontract?

A. I did.

Q. In that connection did Marine Development agree to make such additional payments?

A. They did not. They left it hanging in abeyance, if you please.

Q. Did they ever agree to make such additional payments?      A. May I explain my answer?

The Court: Yes, you may.

The Witness: I informed Mr. Hahn at the time of this July 2nd meeting that before we discussed anything else I wished to ask them about payment to White-Ahlgren for the garage slabs. [217] He said, we have this critical situation so far as the stage of the work is concerned here now, the complaint of the inspectors and all, and I will only answer you in this way, that if you and White-Ahlgren agree to this arrangement of putting Jones in as accountable to Jackson and the work is satisfactorily completed by White-Ahlgren, their contract is completed, we will then reconsider, but I want to make it clear.

The Court: Reconsider what?

The Witness: Reconsider allowing something to them on account of these garage slabs they were claiming they were not paid for.

But he said, I want to make it clear that I am not committing myself to pay a dime at this time or at any future time.

(Testimony of Burton A. Van Tassel.)

Mr. Sherman: Mr. Stacey, may I have Plaintiff's Exhibit 28 for identification?

(The exhibit referred to was passed to Counsel.)

Mr. Sherman: Is this marked Plaintiff's Exhibit 28 for identification, Mr. Clerk?

The Clerk: Yes.

Q. (By Mr. Sherman): Mr. Van Tassel, I now show you a letter addressed to you by Robert A. Oakes, copy of a letter, under date of [218] October 7, 1954. Was that a letter that you received from Mr. Oakes in connection with this garage slab matter? A. It is.

The Court: That is after the completion of the contract?

Mr. Sherman: That is correct, your Honor.

The Witness: Yes, that is right. [219]

\* \* \*

Q. At the time of that July 2nd meeting when additional money from Marine Development was discussed——

The Court: For the slabs?

Mr. Sherman: For the slabs, and this witness testified——

The Court: I know what he testified to.

Q. (By Mr. Sherman): Is it not a fact that prior thereto White-Ahlgren had notified you as the representative of Century that they could not pay their suppliers' bills and that Century In-



(Testimony of Burton A. Van Tassel.)

demnity out of its own funds had paid material men in the sum of approximately \$66,000?

A. That is correct.

Q. Therefore at the time of this discussion with the Marine Development people for additional sums, Century Indemnity already knew, did it not, that it would have to pay amounts under the bond directly?

A. Would you read that question back?

(Question read.)

A. Your question isn't clear, Mr. [221] Sherman.

Q. All right.

Did not Century Indemnity at that time know that it would have to make good its obligation under the bond and pay suppliers from its own funds?

A. I don't think there is any question about that.

The Court: Did Century Indemnity ultimately pay suppliers under this bond?

The Witness: Yes, your Honor.

The Court: How much?

The Witness: Approximately \$119,000.

The Court: Those were all suppliers?

The Witness: Yes.

The Court: Did that include any money paid back to Marine Development?

Mr. Sherman: There were no funds paid back to Marine Development.

The Court: I am asking him.

(Testimony of Burton A. Van Tassel.)

The Witness: There were no funds paid back, your Honor, to Marine Development. There was some recovery made by Century Indemnity Company.

The Court: From whom?

Mr. Sherman: From Marine Development.

The Witness: From Marine Development Company, the retention payment of some \$54,000, together with other recoveries which were made from the White-Ahlgren people or for their [222] account. That is contained in the pretrial conference order, your Honor.

The Court: All right.

Q. (By Mr. Sherman): Now with respect to this letter of March 24th from Mr. Oakes to Eva Cole, Plaintiff's Exhibit 10, are you familiar with it without seeing the document, sir?

The Court: March 24th?

Mr. Sherman: Yes, March 24th or 23rd.

The Court: March 23rd.

The Witness: Yes.

Q. (By Mr. Sherman): Is it a fact, sir, that the letter first exhibited to you by Mr. Waite and Mrs. Cole is not the same letter as Plaintiff's Exhibit 10?

A. I think it is not a fact. In other words, this is the same letter to my knowledge that was originally exhibited to me.

Q. When you first learned about the letter, is it not a fact that you had consultations with Mr. Oakes, the attorney for Marine Development, con-

(Testimony of Burton A. Van Tassel.)

cerning certain revisions in the letter which you wished to have?

A. No question about that.

Q. Were those revisions then further discussed with Mr. Oakes and a compromise revision was made between you? [223] A. Naturally.

Q. Is Plaintiff's Exhibit 10 the letter issued after these conferences between you and Mr. Oakes and the compromise revisions?

A. It is not. It is dated March 23rd.

Q. Pardon me?

A. My discussions with Mr. Oakes, Mr. Sherman, for the sake of clarity, all took place after March 23rd.

Q. I understand that.

A. My meeting with them on April 9th was after March 23rd. This letter is dated March 23rd.

Q. I understand that. But my question to you, sir, is this: Although dated March 23rd, is it not a fact that the language of this letter is in the form of the compromise revision agreed to between you and Mr. Oakes after you first saw the original March 23rd letter?

A. May I examine the letter, your Honor?

The Court: Yes.

(The exhibit referred to was passed to the witness.)

The Witness: It is not. We never agreed to any negotiations nor had any understanding with re-



(Testimony of Burton A. Van Tassel.)

spect to the 24-hour period referred to in that letter, and this was the original letter. [224]

Q. (By Mr. Sherman): Is it not a fact, Mr. Van Tassel, that although this letter of March 23rd is not signed by Century Indemnity Company its contents were agreed to and ratified by you as the attorney for Century Indemnity?

A. That is not a fact.

Q. It is a fact, however, is it not, that after this letter Marine Development did step up its progress payments in accordance with the letter?

A. That is true.

Q. Is it also not a fact, sir, that after the work schedule which White-Ahlgren was required to complete was reduced in accordance with the terms of the letter?

A. That is right.

Q. Did you at any time voice any objection to that?

A. No. This was a verbal understanding between Mr. Oakes and myself that there need be no occasion for the executing of this letter by Century Indemnity Company in view of the satisfaction Mr. Summers expressed in his telephone call to Mr. Oakes.

Q. Even though they were, as you testified, satisfied that there was no default, yet the recommendation specified in the letter was, in fact, carried out?

A. The weekly payrolls and the modification of the rate of work, yes. [225]

Q. Now is it not a fact, sir, that in your weekly trips to the job site you would discuss with Marine

(Testimony of Burton A. Van Tassel.)

Development people the extent and nature of the progress on the job being made?

A. Not particularly with them, no. There would be an estimate sheet made up by Mrs. Higgins reflecting the work that had been estimated as being performed during the past week, which estimate sheet would at the time of the mid-afternoon meeting be presented to Marine Development Company.

At that time there might be some discussion possibly with regard to the amount of work done.

Q. These meetings were customarily held in your presence when you would come down once a week?

A. That is correct.

I would be present at the meeting.

Q. And it would be held on the day that you happened to be there?      A. That is right.

Q. And all discussions concerning the job would be made in your presence at those meetings?

Mr. Burford: That is a little broad, your Honor.

The Court: Yes, a little broad, I would say, all the discussions concerning the job.

Mr. Sherman: Let me reframe it.

The Court: He said he was only there once a week and I [226] suppose the other people were there every day.

The Witness: That is correct.

Q. (By Mr. Sherman): You were present throughout these meetings when they would take place on those days that you were there, in other words, on a given day when a meeting was held and

(Testimony of Burton A. Van Tassel.)

you were there you would be present throughout the meeting?

A. Your question is not clear, Mr. Sherman.

Mr. Burford: What meeting?

The Court: Let me have the question read.

(Question read.)

The Court: The question is not clear. All you are saying is you were there when you were there.

Mr. Sherman: No; all I am trying to establish through the witness is when he was present at these meetings.

Mr. Burford: What meetings, your Honor?

Mr. Sherman: His presence would be there throughout the meeting, not that he would walk in for a few moments and discuss something and walk out and not be there the balance of the meeting.

The Court: Do you know?

The Witness: No; I would be there for the duration of the meeting, however long it was. They were never very long.

The Court: What meeting? Do you know whether or not they had another meeting when you weren't there? [227]

The Witness: Yes, there were occasions when I did not go down there, your Honor. Mr. Waite occasionally went down.

The Court: Did they have a meeting between the Marine Development Company and White-Ahlgren or the various employees that you weren't there?



(Testimony of Burton A. Van Tassel.)

The Witness: That is entirely possible, sir.

Mr. Sherman: The only thing I am trying to establish, your Honor, is when he was present at meetings he was present throughout the length of those meetings and there were no meetings at which he left and in which the discussion continued.

The Court: How can you tell what happened when he wasn't there?

Mr. Sherman: He can tell, your Honor, when he walked out whether the parties were still talking or not.

The Witness: I can clear it up very quickly, Mr. Sherman. There were no meetings that I recall where I ever walked out.

Mr. Sherman: All right.

Q. In your discussion with the Marine Development people concerning what they allege to be this default, did they not indicate to you that the reason for the difficulty which they maintained existed was due to White-Ahlgren's insufficient capital?

A. At what time are you referring to, please?

Q. At the time of your discussion with the Marine Development people concerning White-Ahlgren's alleged falling [228] behind on its progress in completing the job, the March, 1954, situation.

A. Your question isn't clear yet. Are you talking about the time when I met with Mr. Oakes down in his office?

Q. I am talking about the time when in your presence Mr. Oakes received a telephone call from Mr. Summers.

A. All right.

(Testimony of Burton A. Van Tassel.)

Q. Now at that time did any member of Marine Development who was present indicate to you that White-Ahlgren had fallen behind because of insufficient working capital?

A. Mr. Sherman, Mr. Oakes and I were the only ones present. It was in his law office.

Q. Did he so indicate to you?

A. I have no recollection of any such indication by him.

Q. Now with reference to the procedure instituted of meeting the payrolls——

A. May I correct my last answer? I am trying to think back six years.

There may have been a discussion at the time, some comment made, in Mr. Oakes' office by Mr. Oakes to the effect that since White-Ahlgren are in need of funds we will agree on not only the modification of the progress of the work, but paying them by the week.

I think that could well have happened, but I don't [229] have any particular recollection of precisely what was said.

Q. Now the procedure which you say you continued of going down to the job site and counter-signing the individual checks against the trust account, to your knowledge do you know who initiated that procedure?

A. I think that Mrs. Cole did.

Q. With respect to the rates of pay, to your knowledge, were not those rates fixed by union scale?

A. I didn't check as to that.

(Testimony of Burton A. Van Tassel.)

Q. You don't know?           A. No.

Q. It is possible that they were?

A. It is possible.

Q. So that even White-Ahlgren didn't determine that?

The Court: Why don't you sue the union then?

Mr. Sherman: Your Honor, we are not suing anybody; we are being sued.

The Court: Very well. Why didn't you levy the assessment against the union if they are the real employer?

Mr. Sherman: We are not saying the union was the real employer. One who fixes the rate of pay but does not have the money is not the real employer. We feel that Century, having the money and having acted as it did, is the real employer and hence should pay.

I am merely trying to bring out at this point, your [230] Honor, the fact that this witness said he didn't fix the rate of pay. I am trying to show that maybe the rate of pay was not fixed by White-Ahlgren, either; that maybe it was the union scale.

Q. Now, sir, you were furnished on each occasion payroll sheets, recap sheets by Mrs. Higgins, were you not?

A. You refer to them as recap sheets——

Q. Payroll recap sheets.

A. Yes. To the best of my knowledge I received one every time I went down.

Q. With respect to people on the payroll, in addition to those you mention, you knew Mr. Ray,



(Testimony of Burton A. Van Tassel.)

did you not?           A. I knew him.

Q. Did you know his brother, Bill Ray?

A. I believe I remember meeting Bill Ray. Johnny Ray is the one I knew.

Q. Of course, you knew the office staff, did you not, Mrs. Higgins?           A. Yes.

Q. And you knew Mr. Easton?           A. Yes.

Q. And you knew Mr. Hoover, did you not?

A. That is right.

Q. With reference to the suppliers, you have testified that you had certain types of contact with them. Could you [231] please explore that a little further and tell us what other dealings, aside from discussing additional time, you had with them?

A. The particular occasion I had in mind was the one, if I recall correctly, just ahead of June 8th, of the payment for the concrete bill for the month of May. My recollection, if it serves me correctly, it was due on June 10th and it was apparent that there would be no money with which to pay it; that it would be far and away an insufficient fund with which to meet the concrete bill of some \$62,000. They were threatening, the Nelslo Company were threatening, to cut off any further material unless they were paid this substantial sum by June 10th.

I so notified—in other words, that threat was made to me on the phone; I am trying to answer your question—I so notified my people by long distance and received their authorization to pay it so long as it was approved by White-Ahlgren, and I

(Testimony of Burton A. Van Tassel.)

obtained from them a letter certifying that the material had been used on the job, that they had insufficient funds with which to pay it, and requesting Century as its surety to pay it.

Q. Did you dictate that letter, sir?

A. I wrote it in longhand, as I recall.

Mr. Sherman: May we have this marked Defendant's Exhibit next in order, please? [232]

The Clerk: AB.

(The document referred to was marked as Defendant's Exhibit AB for identification.)

The Court: That is a letter of what date?

Mr. Sherman: June 10, 1954.

Q. Mr. Van Tassel, I now hand you that which has been marked Defendant's Exhibit AB for identification, being a copy of a letter dated June 10, 1954, addressed to The Century Indemnity Company by the White-Ahlgren Company, Inc.

I ask you, sir, if that is a copy of the letter you testified about?

The Court: You mean, is that the letter he just testified about having written by hand? He just said that he wrote a letter by hand.

Mr. Sherman: All right. Let me rephrase it this way, your Honor:

Q. Is this a typed copy containing the same contents as the letter written by you in hand?

A. That is right.

Q. Was the letter written by you in hand signed

(Testimony of Burton A. Van Tassel.)

by the White-Ahlgren people or was it retyped and signed?

A. I am certain that it was signed. To the best of my recollection it was signed at the time.

Mr. Sherman: Offer it in evidence as Defendant's Exhibit AB, your Honor. [233]

The Court: Admitted.

(The document referred to was marked as Defendant's Exhibit AB, and received in evidence.)

Q. (By Mr. Sherman): Now, Mr. Van Tassel, in your dealings with White-Ahlgren and Marine Development on this job, did you ever have any dealings with a party by the name of Stewart concerning trucks and equipment used on the Camp Pendleton job that had been attached?

A. I had no dealings with Stewart. There is a Stewart, as I recall, who was the nominal plaintiff in an action against White-Ahlgren in which his trucks were attached.

Q. Did you do anything in connection with the attachment?

A. Yes, I talked to Attorney Adele Walsh or Welsh—I have forgotten which—Pines and Walsh, with regard to lifting that attachment, could some arrangement be made so that the trucks which had been attached, a portion of them, could be put back on the job and utilized.

Q. As a result of those discussions was a written



(Testimony of Burton A. Van Tassel.)  
agreement effected between White-Ahlgren and the attaching party?

A. I think Mrs. Walsh prepared a confession of judgment with regard to it.

Mr. Sherman: May we have this marked as Defendant's next [234] in order, please?

The Clerk: Defendant's Exhibit AC.

(The document referred to was marked as Defendant's Exhibit AC for identification.)

The Court: What is this?

Mr. Sherman: This is an agreement, your Honor, pertaining to this matter which I would like the witness to testify about.

The Court: Let me identify it in my notes first.

(The exhibit referred to was passed to the Court.)

Q. (By Mr. Sherman): You have before you, Mr. Van Tassel, a copy of what appears to be an agreement pertaining to an action in the Superior Court of the State of California, in and for the County of Los Angeles, further pertaining to an attachment and release of attachment. Do you recognize that document, sir?

A. I recognize my handwriting on the first page in the upper corner.

As I read it over, it looks as though it was a part of the understanding at the time.

Q. In connection with the execution of this

(Testimony of Burton A. Van Tassel.)

agreement, did you represent White-Ahlgren in that matter?      A. I did.

Q. As a result of the execution of this agreement some [235] of the attached equipment was released and allowed to continue on the job?

A. Yes, sir.

Mr. Sherman: Offer it into evidence as Defendant's Exhibit AC, your Honor.

The Court: The agreement was executed, was it?

Mr. Sherman: I believe it shows that.

The Witness: I have conformed the copy there, your Honor. That appears to be my copy.

The Court: Very well. It is admitted.

(The document referred to was marked as Defendant's Exhibit AC, and received in evidence.)

Mr. Sherman: May I have Plaintiff's Exhibit 27 in evidence, Mr. Clerk?

(The exhibit referred to was passed to Counsel.)

Q. (By Mr. Sherman): As best you can now recollect, Mr. Van Tassel, when was that agreement executed?

A. I didn't examine the date, Mr. Sherman. It was some time in May or June, I presume, of 1954. I presume the date appears on the document.

Q. No; it does not; that is why I asked you.

The Court: There is no date? [236]

Mr. Sherman: The date does not appear.

(Testimony of Burton A. Van Tassel.)

The Court: It doesn't even show a date of the lawsuit.

The Witness: It shows a month, does it not, on the first page?

Mr. Sherman: No, it doesn't. It is blank as to the date except for the year 1954.

The Court: This blank day of blank.

Mr. Sherman: That is why I was trying for the record to fix the approximate time.

The Witness: I see. I would guess it was somewhere around May or June of that year.

Q. (By Mr. Sherman): Now, sir, I hand you Plaintiff's Exhibit 27 in evidence——

Mr. Burford: I was wondering about Exhibit 27, if that has been admitted?

Mr. Sherman: I believe so.

The Court: I do not remember. Let me see it.

(The exhibit referred to was passed to the Court.)

The Court: No; it is only marked for identification.

Mr. Sherman: I am sorry.

The Court: You can still examine him on it.

Mr. Sherman: Yes, I can, but I thought it had been offered and admitted, your Honor. [237]

Q. Mr. Van Tassel, Plaintiff's Exhibit 27 for identification, do you recognize that document?

A. I do.

Q. Is that an assignment of the rights made to Century Indemnity by the White-Ahlgren Com-



(Testimony of Burton A. Van Tassel.)

pany? A. It so states, yes.

The Court: What is the date of it?

The Witness: The 28th day of May, 1954.

Q. (By Mr. Sherman): Do you know who drew up this assignment? A. Yes; I did.

Mr. Sherman: Offer it into evidence, your Honor, as Defendant's Exhibit marked Plaintiff's 27.

The Court: It may be admitted.

(The document referred to was marked as Plaintiff's Exhibit No. 27, and received in evidence.)

Q. (By Mr. Sherman): Now in connection with that, Mr. Van Tassel, did you have anything to do with the filing by White-Ahlgren of a mechanics' lien against the Crevette Construction Company?

A. I did.

Q. Please tell us what you did in that regard.

A. I requested the information as to what work had been performed by White-Ahlgren on the four different units of the [238] Claremont Gardens tract, separate mechanics' liens were then written up and executed by Mr. Ahlgren, as I recall.

Q. Was this Crevette Construction Company job also commonly known as the Webb & Knapp job?

A. That is correct.

The Court: This Exhibit 27 is an assignment which relates to that Crevette job, or whatever it is?

Mr. Sherman: Yes.

(Testimony of Burton A. Van Tassel.)

The Court: It does not relate to any sums due in the job on the Base?

Mr. Sherman: That is correct, your Honor.

The Court: Very well.

Q. (By Mr. Sherman): In connection with that Crevette job you actually did such work as was necessary to accomplish the filing of mechanics' liens? A. Yes.

Q. Now, Mr. Van Tassel, with respect to the presentation to you on April 30th of this check and return for payment of Federal taxes——

The Court: Is that in evidence?

Mr. Sherman: No; I believe the witness testified, your Honor, that on April 30th——

The Court: I know, but I wondered if that return or a photostatic copy was in evidence. [239]

Mr. Sherman: No; they are not in evidence, your Honor.

Q. I believe you testified in that regard, did you not, that the only reason it wasn't paid at that time was that there were insufficient funds in trust account to pay it in full?

A. I testified that that was one of the reasons why I did not sign the check.

The Court: Did you testify it was the only reason?

The Witness: Well, I think I perhaps did.

The Court: And it was the only reason?

The Witness: That was the only reason at that time, yes.

Q. (By Mr. Sherman): Is it not true, sir, that

(Testimony of Burton A. Van Tassel.)

during this same month of April payrolls were being made, were they not?       A. Certainly.

Q. Suppliers were being paid, were they not?

A. In part, yes; not in full.

Q. Well, taking that month of April, would it be correct to state that approximately \$50,000 was paid to suppliers in that money alone?

A. Mr. Sherman, I do not have the records before me. I can't answer your question.

Q. Does that figure sound out of line to you?

A. I wouldn't attempt to appraise it.

Q. Now, after April 30th, did you ever okay a check for [240] payment of those taxes?

A. I did not.

Q. Did you ever transfer——

The Court: Was it ever present to you by White-Ahlgren or any of their employees?

The Witness: I don't recall any subsequent presentation of any payroll tax checks, your Honor. I recall that they were discussed, but the same situation prevailed. Whether subsequent payroll tax checks were prepared or not, I don't presently recall.

Q. (By Mr. Sherman): Irrespective of whether or not a check was put in front of you, were you requested at any subsequent time to authorize the issuance of a check against the trust account for payment of taxes?

A. I don't recall, Mr. Sherman. I may have.

Q. But, in fact, you know you did not actually?



(Testimony of Burton A. Van Tassel.)

A. I know I did not countersign any checks for payroll taxes.

Q. For that period or any subsequent period?

A. That is correct.

The Court: Did White-Ahlgren have another bank account at that time?

The Witness: They had had, your Honor, in the early stages a general account known as White-Ahlgren Company, Inc. [241] Whether there were any funds remaining in it at that time, I do not know.

Mr. Sherman: Your Honor, in that regard I believe Defendant's Exhibit E is the bank ledger of that account showing the status of it throughout this period.

Q. Now, Mr. Van Tassel, did you ever seek to set aside from the trust fund any of the payroll taxes as a separate fund? A. No.

The Court: When you say that that was the only reason why this wasn't paid, you mean by that to express that in your opinion those taxes were due and payable out of that account, the payroll account, and not otherwise payable by White-Ahlgren?

The Witness: Your Honor's question isn't clear to me.

The Court: You said the only reason this check was not paid was because there wasn't sufficient money in the payroll account, the trustee account.

The Witness: In the trustee account.

The Court: And by that statement, do you mean

(Testimony of Burton A. Van Tassel.)

to give it as your opinion that that is the only account from which those taxes could have been collected, or could they have been collected from other assets and property of White-Ahlgren?

The Witness: They might have been collected in part at least, I would guess, from other assets of White-Ahlgren. I hadn't any knowledge as to that at that time. My knowledge of [242] the situation was restricted to what the trustee account itself revealed as to a checkbook or a bank balance.

This was all in the early stages, if your Honor please, when I was getting my feet wet on the job.

The Court: I understand. The implication of your answer is that the only reason it wasn't paid is that there wasn't any money and that that account owed the money, and if you had control of the account you owed the money, if that is what you mean to say.

The Witness: That is what I mean to say, that there was insufficient money in that account with which to meet those payroll taxes at that time and I therefore declined to countersign a check.

The Court: And that is the only reason the tax was not paid?

The Witness: Yes.

The Court: It looks to me like that is about the end of your lawsuit, Counsel.

Mr. Burford: I don't think so, your Honor.

The Court: I mean, if that is the only reason the tax wasn't paid then the tax was due out of that account.

(Testimony of Burton A. Van Tassel.)

Q. (By Mr. Sherman): Mr. Van Tassel, after this April 30th discussion with Mrs. Higgins, you did continue to pay payroll, did you not, out of the trust account? [243]      A. We did.

Q. And you did continue to pay suppliers out of the trust account, did you not?

A. That is right.

Q. At any time after April 30th was there sufficient balance in the trust account to meet any of the Federal taxes then due?

A. After April 30th?

Q. Yes.      A. Not payroll.

Q. It was always less than \$11,000?

Mr. Burford: I object to that, your Honor.

The Court: Do you know?

Mr. Sherman: The witness has made a statement, as I understand the witness' testimony, that as far as he knows it was never sufficient.

The Court: Did you see the bank statements on that account?

The Witness: Did I see the bank statements?

The Court: Yes.

The Witness: I did not see the bank statements.

The Court: How do you know what they had in the account then?

The Witness: We had a running record which I kept, along with Mrs. Higgins, the bookkeeper. Every week when I went down [244] there, your Honor, we would keep a rather running record showing what the balance was the previous week, how much we were depositing into the account,



(Testimony of Burton A. Van Tassel.)

what the payment amounted to, what amount of material bills were paid, and we arrived again at the end of each week at a very low balance, a matter of \$2,000 or \$3,000.

The Court: Look at the trust account before you testify—you better look at it—it shows balances of \$14,000, \$15,000.

The Witness: (Examining exhibit.)

The Court: Unless you are just trying to find out whether or not he knew whether or not there was sufficient funds whether or not he knew what the balances were.

Mr. Sherman: No; I am trying to establish whether or not at any time when other bills were being paid that he knew there was sufficient money there so that this could have been paid in lieu of those other bills.

Mr. Burford: It seems to me, your Honor, that the bank account speaks for itself.

The Witness: The question, your Honor clarified for me, and as far as that is concerned I am not paying any attention to these earlier sheets because I was not in the picture at that time, and as of April 30th your Honor will note that there is a bank balance, according to this of \$4,071. Then we put in \$14,000 here—it is recorded there as May 1st but as soon [245] as all these many payroll checks are drawn against it, it reduces very quickly to a relatively small balance—but the matter of meeting, if there were such funds on hand so that the material bills and the payroll could have been

(Testimony of Burton A. Van Tassel.)

met, we then would, had there been that excess, have gone ahead and paid the payroll taxes. But we were meeting the payrolls which had to come first and the material bills had to come second.

Q. (By Mr. Sherman): And the payroll taxes third? A. That is right.

Q. Now, at the time of this April 30th discussion, when there was, as you testified, insufficient funds to meet it in full, were there any funds to meet any part of it?

A. It is my recollection that there were funds of approximately \$3,000. It may have been between \$3,000 and \$4,000.

Q. Did you indicate or suggest that you would authorize a check for that amount or some lesser amount? A. I did not.

Q. As a matter of fact, sir, didn't you indicate that you wouldn't approve any check unless there was sufficient funds to meet it all?

A. I don't recall that.

Mr. Sherman: Mr. Clerk, may I have Defendant's Exhibits D, F and G—pardon me, make that F, H and J. [246]

(The exhibits referred to were passed to Counsel.)

The Witness: Your Honor, may I supplement my last answer?

The Court: Yes.

The Witness: If Mr. Sherman is purporting to cover the matter of sufficient funds on hand with

(Testimony of Burton A. Van Tassel.)

which to pay the payroll taxes at any given time, the bank statements would indicate enough of a balance on occasion in the account with which to pay the payroll taxes, but it was necessary, as far as White-Ahlgren was concerned, to go ahead and meet the payrolls and you had to build up a balance with which to do that and to meet the material bills as far as you could go, and you had to build up a balance to do that.

Q. (By Mr. Sherman): Would this be a fair statement, sir, if there was sufficient funds to meet it all you would have authorized it all, but there not being sufficient funds, and you having to pick and choose your order of priority was payroll first, suppliers second, would that be a fair statement?

A. Yes.

Q. Now, Mr. Van Tassel, I show you——

The Court: Did White-Ahlgren or anybody ever say how they were going to pay these payroll taxes or other taxes? Did you have any discussion with them about that? [247]

The Witness: When I was first in the picture there was this matter of garage slabs talked about as a possible \$50,000 recovery. There was also the purported balance which was due from Webb & Knapp on the Claremont Gardens job.

So that in connection with each of these there appeared to be sufficient money.

The Court: Did you have a discussion with them about that?

The Witness: Oh, yes, I did.



(Testimony of Burton A. Van Tassel.)

The Court: What did they say, that that is where they were going to get the money to pay the payroll taxes, and so forth?

The Witness: They weren't talking so much about the matter of payroll taxes right then as the matter of future possible recoveries.

The Court: All right.

Q. (By Mr. Sherman): In that regard, Mr. Van Tassel, with reference to the possibility of the Webb & Knapp payments, all of White-Ahlgren's rights to the Webb & Knapp payments were assigned to Century Indemnity as of May 28, 1954, is that not correct?      A. That is right.

Q. With respect to the \$50,000 additional funds on the garage slabs, at no time to your personal knowledge did Marine Development ever promise they would make such a payment, is that [248] not correct?

A. They didn't promise they would make any such payment. They said they would consider it again.

Q. Finish the job and we will see you then?

A. Yes.

Q. So you knew they had never indicated that they would?

A. I haven't testified at any time they did.

Q. I now show you Defendant's Exhibit F for identification, Mr. Van Tassel. Do you recognize that document?      A. I do.

Q. That is an agreement of release and indemnity whereby Century Indemnity Company agrees

(Testimony of Burton A. Van Tassel.)

to indemnify the Marine Development Company against any claim of the United States, of the State of California, or of a garnishee named Ocean House, Inc., and another possible claimant to the 10% retention monies in consideration of Marine Development transferring those funds to Century Indemnity Company.

A. That is what the agreement says, yes.

The Court: That indemnifies Marine Development?

Mr. Sherman: That indemnifies Marine Development against any——

The Court: Liability on taxes involved in this case?

Mr. Sherman: Yes, if they turn certain monies that Marine Development held over to Century Indemnity Company.

The Witness: Pardon me, your Honor. Mr. Sherman's answer [249] is rather all-inclusive.

The only claim for taxes which was involved is Item No. 1 there in the sum of \$12,000-odd.

The Court: Payroll taxes?

The Witness: Payroll taxes.

Mr. Burford: That is for the fourth quarter of 1953 only, your Honor, not for the taxes here in issue, in total.

Mr. Sherman: I think the stipulation between the parties shows this, your Honor, that prior to the execution of this agreement Marine Development was served with a levy by the Internal Rev-

(Testimony of Burton A. Van Tassel.)

enue Service and the levy was in the amount of \$12,718.11.

The Court: Those taxes are not involved in this case?

Mr. Sherman: They are involved.

Mr. Burford: They are, but this is only a part of them.

Mr. Sherman: This is a part of the whole.

The Court: Yes. In other words, these are the payroll taxes.

Mr. Sherman: Yes.

The Court: You also have withholding taxes.

Mr. Burford: For one quarter.

You see, the fourth quarter of 1953 and the first three quarters of 1954 are involved, and the only point we are making was that when you say these are the taxes issued therein, they are some of [250] them.

The Court: It is a part of the taxes?

Mr. Sherman: It is a part of the taxes.

The Court: All right.

Q. (By Mr. Sherman): This agreement, Mr. Van Tassel, was executed by you as attorney and agent in fact of The Century Indemnity Company?

A. That is how it was specified there. It was executed by me.

Q. You received specific telegraphic authority from The Century Indemnity Company to so execute it, did you not?      A. I did.

Mr. Sherman: Offer it into evidence, as Defendant's Exhibit F, your Honor.



(Testimony of Burton A. Van Tassel.)

The Court: It is admitted.

(The document referred to was marked as Defendant's Exhibit F, and received in evidence.)

The Court: What is meant by payroll taxes?

Mr. Sherman: I think it is a broad term, your Honor, which includes the withholding of the employee, his share and the employer's share of the Social Security taxes, and also the unemployment tax.

Mr. Stacey, do you have Exhibit H?

The Clerk: I gave it to you already. [251]

Q. (By Mr. Sherman): Mr. Van Tassel, I now hand you that which has been marked Defendant's Exhibit H for identification, which purports to be Check No. 2468, made by the Marine Development, Inc., company payable to The Century Indemnity Company in the amount of \$54,249.18. Did you receive that check pursuant to the execution of this agreement of release and indemnity, Defendant's Exhibit F?           A. I did.

Q. What did you do with that check?

A. I sent that through to The Century Indemnity Company at Hartford, Connecticut.

The Court: That is Exhibit what?

The Witness: That is Exhibit H, your Honor.

Mr. Sherman: I offer it into evidence as Defendant's Exhibit H, your Honor.

The Court: It is admitted.

(Testimony of Burton A. Van Tassel.)

(The document referred to was marked as Defendant's Exhibit H, and received in evidence.)

Q. (By Mr. Sherman): And that represented the final 10% retention monies that Marine Development had at the time? A. Yes.

Q. By this time, of course, sir, Century Indemnity had [252] expended out of its own funds monies in payment of suppliers on the Camp Pendleton job? A. For materials, yes.

Q. In addition to indemnifying Marine Development Company with respect to any liability they might suffer if they surrendered this check to you, did you also indemnify Marine Development—and by “you,” I mean Century Indemnity—did you also indemnify Marine Development against any tax claims of the State of California, if they continued to make wage payments on the job?

Mr. Burford: Are you referring to this——

The Court: Exhibit F?

Mr. Sherman: I am not, sir. Let me rephrase the question.

Q. In addition to the indemnifications contained in Exhibit F, did you on behalf of Century Indemnity execute any documents wherein you agreed on their behalf, or Century Indemnity agreed, to indemnify Marine Development Company against any tax claims of the State of California if Marine Development continued to deposit the progress payments into the trust account rather than divert any

(Testimony of Burton A. Van Tassel.)

of those payments to paying State of California taxes?

A. We indemnified them to a limited extent, Mr. Sherman. Your question is too broad.

Q. You did indemnify them to some extent, then? [253]

The Court: When, before or after the job was finished?

The Witness: Before the job was finished.

The Court: Before the job was finished?

The Witness: Yes.

The Court: We will recess until 2:00 o'clock.

Mr. Sherman: Before we do that, may I just put this in?

Q. Mr. Van Tassel, I show you Defendant's Exhibit G for identification. Is that the letter of indemnification that you are speaking about with reference to the State of California?

A. That is right. [254]

\* \* \*

### Redirect Examination

By Mr. Burford:

Q. Mr. Van Tassel, this morning you testified, I believe, on direct examination or cross-examination, or both, that you as the trustee for Century would have countersigned a check for the payroll taxes, that would be the amount due from the employer for Federal income tax withheld, Social Security taxes and Federal unemployment tax, had



(Testimony of Burton A. Van Tassel.)

there been enough money in the bank account to make this payment. Would you explain to Judge Hall what you meant by that statement?

A. I will repeat, that what I had in mind was that if there was sufficient money to meet the payrolls and the material bills with an excess over and above that, that then we would have paid the payroll taxes. [258]

Q. In other words, I believe——

Mr. Sherman: Your Honor, I will object to Counsel's redirect. This is a critical issue in the case, the witness is an attorney, this is redirect examination, and I do not think it is proper under all circumstances for counsel to lead this witness to get the answer counsel wishes.

I think if he has pertinent questions on redirect he should ask them without stating to the witness what answers he desires and merely expect a yes or no answer.

The Court: He hasn't, but he was giving an indication that he was about to by his use of "in other words."

Mr. Sherman: Yes, your Honor.

Mr. Burford: I will withdraw the question, your Honor.

Q. Mr. Van Tassel, what were the lienable claims under the bond of Century Indemnity?

A. They were claims for materials which were furnished to and used in the job.

Q. Were there other lienable claims under the bond?

(Testimony of Burton A. Van Tassel.)

A. Labor would have been a lienable claim, yes.

Mr. Burford: At this time, your Honor, I offer in evidence Plaintiff's Exhibit 20 for identification, which is a schedule of payment made by Century Indemnity to creditors of White-Ahlgren.

The Court: Very well.

The Clerk: Plaintiff's Exhibit No. 20. [259]

(The document referred to was marked as Plaintiff's Exhibit No. 20 and received in evidence.)

Mr. Burford: The total amount is in the stipulated facts. This just gives a breakdown.

Q. Mr. Van Tassel, I direct your attention to Plaintiff's Exhibit 20——

The Court: That is payment by Century Indemnity Company?

Mr. Burford: That is correct, your Honor.

Q. ——that shows a payment on June 10, 1954, to Nelslo Corporation of \$62,143.72?

A. That is right.

Q. What was that payment for, Mr. Van Tassel?

A. That covered the May deliveries of mixed concrete to the job.

Q. How did Nelslo render its billing forms for mixed concrete?

A. I saw billings which were in the construction shack of White-Ahlgren Company which I understand had been delivered to Mrs. Higgins by the foreman on the job, one of the foremen on the job,

(Testimony of Burton A. Van Tassel.)

these being delivery slips as each truckload of mixed concrete came in and dumped its load.

Thereafter the billing would be made up, as I recall, from the accumulation of these delivery tickets indicating quantities. [260]

Q. Which were payable how often, did you say?

A. They were payable on the 10th of the month following the month in which the deliveries were made.

Q. Now, Mr. Van Tassel, Judge Hall asked you before recess at noon what sort of record you kept of what was in the White-Ahlgren Trust Account No. 1. Would you explain for his benefit what sort of record you maintained as to the status of that account?

A. Yes. I continued the practice by Mrs. Cole of a running record of checks drawn against the Trust Account No. 1 with this explanation necessary, that when it came to the matter of payroll I would show that as payroll ending such and such a week in the lump sum, or the total of the net wages, rather than listing each individual employee's name and amount.

But other than that, we kept a running record, payroll, for example, \$10,789 and odd cents, and then a separate listing of each individual check which we drew for materials.

The Court: Where did you get the information, from White-Ahlgren's bookkeeper?

The Witness: From White-Ahlgren's bookkeeper.



(Testimony of Burton A. Van Tassel.)

The Court: Did you have access to their bank statements?

The Witness: I wasn't checking their bank statement.

The Court: No. No. Did you have access to them?

The Witness: I had access to their [261] checkbook.

The Court: But did you have access to the bank statements which have been introduced here in evidence?

The Witness: I didn't make it a practice of doing so.

The Court: Did you ever go to the bank to check up to see what their balance was, or whether or not they had the money in the bank that they said they had?

The Witness: No.

The Court: Did they show you a bank statement?

The Witness: I don't recall that they ever showed me a bank statement. Mrs. Higgins and I would try to reconcile our records with respect to the running balance.

The Court: In the checkbook?

The Witness: In the checkbook, and she would confirm to me what the amounts were, if we had any differences, in other words.

On one occasion we did have. I corrected it in my running record. But she knew what the total of the payroll checks were, she knew what each

(Testimony of Burton A. Van Tassel.)

material bill that was paid was, and she kept a running record of it.

The Court: Did you ever deposit any money in the account, whatever the name of this account is?

Mr. Burford: Trust Account No. 1.

The Court: Trust Account No. 1.

The Witness: I accompanied Mr. White——

The Court: No; did you ever go down and make a deposit? [262]

The Witness: I went with him, yes, to the bank, to the Carlsbad branch.

The Court: When they put their money in?

The Witness: When they put the trust account check in, the Marine Development Company's check payable to White-Ahlgren Trust Account No. 1.

The Court: Did you put it in?

The Witness: They would go to the window.

The Court: Who was it payable to?

The Witness: It was payable to White-Ahlgren Trust Account No. 1.

The Court: Did you endorse it?

The Witness: I don't recall that I did. I may have. But I don't recall that that was required. I mean, it was simply for deposit only, White-Ahlgren Trust Account No. 1, by so and so.

Mr. Burford: I think, your Honor, the stipulation of facts is that all of the progress payments made under this contract were deposited to the account of White-Ahlgren in the Trust Account No. 1.

The Court: I understand that stipulation of facts, but the government is contending here that

(Testimony of Burton A. Van Tassel.)

he on behalf of The Century Indemnity Company was, in truth and in fact, the contractor. That is what they are trying to establish.

Mr. Sherman: The frame of reference is that I think [263] plaintiff has to establish that they were not by their conduct the employer and, second——

The Court: Your position then, let us say——

Mr. Sherman: Our position is that the evidence will fail to show that plaintiff was not in control, realistically speaking, of the running of this job and, most important as bearing upon the running of this job, the financial control whereby the company could run the job.

That is our position and our contention.

The Court: I am stating it a little more bluntly than you are. The net essence of your contention is that Century Indemnity was, in truth and in fact, running the business.

Mr. Sherman: Was in control of it. We think that word “control” is the important thing under the Ninth Circuit decisions, your Honor.

The Court: In any event, that was the purpose of my question. It isn't a question of the stipulation; the question is whether or not he for Century Indemnity got the money from Marine Development, took it and deposited it in the account.

Did you ever do that?

The Witness: I have no recollection of doing that. I may have. I certainly went with them.

Your Honor objected to my stating what I did. On each occasion we wanted to be certain that the



(Testimony of Burton A. Van Tassel.)

money went into the bank. None of us wanted to be countersigning checks [264] against an account which would not have the money in it.

The Court: Did you go with them on every check that they deposited, or do you know?

The Witness: I think that I accompanied them in most of the instances when I was down there, yes.

The Court: Just when you were there?

The Witness: Pardon me?

The Court: Did you ever see the bank statements until this morning?

The Witness: Yes; I had seen copies of them before.

The Court: Did you ever notice the deposits made on there?

The Witness: No. I mean, I did not check them. We had an accountant go over this, your Honor.

The Court: I understand.

The Witness: I wasn't attempting to verify his work.

The Court: All I am trying to find out is whether or not you were the boss man.

Mr. Burford: Your Honor, I don't want there to be any doubt in your mind. I would like to clarify the facts for your Honor in this respect, if I may.

Q. Mr. Van Tassel, you stated that you went down to——

Mr. Sherman: Your Honor, I dislike to interrupt——

The Court: He has a right to refer his question

(Testimony of Burton A. Van Tassel.)

on direct examination. He hasn't come to his question yet. [265]

Mr. Sherman: I thought Counsel was making a statement at this point.

Mr. Burford: I will phrase it this way:

Q. When did you go to Camp Pendleton normally? A. On Friday of each week.

Q. When did Marine Development make progress payments to White-Ahlgren?

A. On Friday of each week.

Q. What was the basis for these payments?

A. The amount of work which had been done during the past week up until I think Wednesday of the week on which the Friday followed.

Q. Do you know how those statements were prepared?

A. You are talking about the statement to Marine Development?

Q. The statement to Marine Development.

A. They were prepared, I understand, by Mrs. Higgins ordinarily based upon computations by Mr. White and Mr. Ahlgren perhaps, and Mr. Ray perhaps, of the work done during the past week for which they might render a bill, and those estimates then, if we may call them that, were then submitted to Marine Development Company for checking by them.

On occasion they might decide in their check on the amount of work done that it was somewhat overstated and cut down the amount they were willing to pay on that given Friday. [266]

(Testimony of Burton A. Van Tassel.)

Q. Those statements were the ones on which the bills were rendered and the progress payments were made? A. That is right.

Q. Did you ever see those statements or any of them when you were down there on Friday?

A. Yes; on occasion I was furnished with a copy by Mrs. Higgins.

Q. Where was that?

A. That would be in the White-Ahlgren Company construction shack.

Q. Then after these statements had been rendered and approved, what was done with them?

A. They would have been furnished Marine Development, a copy or perhaps the original of that statement, which was checked over by it, and either approved or slightly modified downward, as the case might be, and we would then—"we" meaning Mr. White, Mr. Ahlgren and I—ordinarily would go over to the headquarters building of Marine Development, usually in the mid-afternoon, and meet with them, at which time they would draw a check for the amount they were willing to pay for that past week's work.

Q. Where was this bank account in which the check was deposited, that is, the White-Ahlgren Trust Account No. 1?

A. That was in the Security Trust & Savings Bank and they were deposited in their branch bank in Carlsbad. [267]

Q. For that account in the main office in San Diego? A. That is correct.



(Testimony of Burton A. Van Tassel.)

Mr. Burford: I just wanted to clear up the mechanics of how this was actually handled.

The Court: Very well.

Now on this Exhibit 20, this is a list of payments made by Century Indemnity, where they paid from this Trust Account No. 1?

The Witness: Oh, no.

The Court: These were paid by Century Indemnity checks?

The Witness: That is correct.

The Court: Very well.

Q. (By Mr. Burford): Now, Mr. Van Tassel, I call your attention to Defendant's Exhibit D, which is a transcript of the White-Ahlgren Trust Account No. 1 bank account.

Will you look at that bank statement and state what it shows to be the bank balance as of April 30, 1954.

A. It shows a balance of \$4,071.18.

Q. Now going on down this statement, Mr. Van Tassel, you will see deposits and withdrawals and balances from time to time.

Will you explain to the Court how you determined how much money you needed in the bank to meet material bills and labor payroll? [268]

The Court: I understood he did not see these.

Did you use the bank statement in that connection at all, or did you rely upon the statement prepared by this bookkeeper and their checkbook?

The Witness: I relied on the checkbook, as far as that is concerned.

(Testimony of Burton A. Van Tassel.)

The Court: On the checkbook?

The Witness: Yes.

Mr. Burford: Well, your Honor, the balance in the bank would not correspond exactly with the balance as shown on the books because, of course, there would be checks outstanding.

The Court: I do not suppose it would.

Mr. Burford: Perhaps we should introduce the books. The purpose of this testimony was not to show exactly the balance at what time. May we wait until the books are introduced?

The Court: What is the purpose of the books?

Mr. Burford: The purpose of it, your Honor, was directed to the proposition this morning that at a particular time there would be a balance in the bank account, which, of course, there was, and my purpose is to show how the balance went up and down as the payment of suppliers and material bills came in which they knew would be due.

Mr. Sherman: Perhaps we can save the trouble. I will stipulate, your Honor, that the balance fluctuated with the [269] payment of payroll and material, if that is what Counsel is interested in. There is no question about that.

The Court: I do not think there is any need of encumbering the record here with the books and records of the company. The question involved here in this case is not so much the status of the White-Ahlgren Company as it is what this plaintiff had to do with it, and he has testified to that, and I think

(Testimony of Burton A. Van Tassel.)

that would be sufficient without introducing the books.

I inquired of that because I wanted to know whether or not he ever used this bank statement, and he has testified that he did not, that he and the bookkeeper used the checkbook to check against the checks and withdrawals.

Mr. Burford: I believe, your Honor, unless you have any further questions, that is all I have.

The Court: I do not have any questions.

Mr. Sherman: Your Honor, a few points were brought out on redirect that I would like to go into.

The Court: Very well.

Incidentally, in going through the bank statements I notice that practically all bank deposits were credited on Monday.

Mr. Burford: Possibly deposited Friday and it would show up as a Monday credit.

The Witness: It is a branch bank. [270]

### Recross-Examination

By Mr. Sherman:

Q. Mr. Van Tassel, after you became an authorized trustee on this bank account, do you know to whom the bank statements were mailed by the bank?

A. I do not.

The Court: Were they mailed to you?

The Witness: They were not mailed to me.



(Testimony of Burton A. Van Tassel.)

Mr. Sherman: May we have these marked Defendant's Exhibit next in order, please?

The Clerk: AD.

The Court: Are they a group, a series?

Mr. Sherman: Just two each. I believe they should be separately marked, your Honor.

The Court: That will be AD and AE.

(The documents referred to were marked as Defendants' Exhibits AD and AE, respectively, for identification.)

Q. (By Mr. Sherman): Mr. Van Tassel, I now hand you that which has been marked Defendant's Exhibit AD for identification, being a check made by Marine Development, Inc., payable to the White-Ahlgren Trust Account No. 1 under date of July 23, 1954, in the amount of \$58,019.76.

Will you examine that check, sir, and will you please [271] examine the endorsement on the reverse side thereof? A. I have.

Q. Would you please read that endorsement, sir?

A. "For deposit only, White-Ahlgren Trust Account No. 1, by Burton A. Van Tassel, Trustee."

Q. Is that your handwriting, sir?

A. It is.

Q. You then deposited this check in the trust account? A. I endorsed it.

Mr. Sherman: Offer it in evidence, your Honor.

The Court: Admitted.

(Testimony of Burton A. Van Tassel.)

(The document referred to was marked as Defendant's Exhibit AD and received in evidence.)

Q. (By Mr. Sherman): Mr. Van Tassel, I now hand you that which has been marked Defendant's Exhibit AE for identification, being another check made by Marine Development, Inc., payable to White-Ahlgren Trust Account No. 1, under date of September 3, 1954, in the amount of \$558.18. Will you please examine the endorsement on that check?

A. I have.

Q. Is that endorsement also yours?

A. It is.

Mr. Sherman: I offer it in evidence as the Defendant's [272] Exhibit next in order.

The Court: It will be received.

(The document referred to was received as Defendant's Exhibit AE in evidence.)

The Court: Do you recall the circumstance of getting either one of these checks?

The Witness: I don't recall, your Honor.

Q. (By Mr. Sherman): Mr. Van Tassel, at any time while you acted as trustee of the White-Ahlgren Trust Account No. 1 was your authority and approval a condition precedent to the issuance of Marine Development Company of any of its progress payments to the trust account?

The Court: Or to White-Ahlgren?

Mr. Sherman: No—well, your Honor, I believe

(Testimony of Burton A. Van Tassel.)

that with one or two exceptions all checks were made payable directly to the trust account.

The Court: All right.

Mr. Sherman: And the one or two exceptions were deposited in the trust account. This is by stipulation of the parties.

The Court: Very well.

The Witness: I recall that it was common practice for the Marine Development Company to require a letter of consent executed by the person representing the Century as trustee, that being unquestionably due to the change in progress [273] payments, they didn't want their bond exonerated, didn't want the surety company exonerated because the progress payments were changed.

The Court: A letter of consent to what?

The Witness: To the Marine Development Company consenting to the payment of the particular amount on each given week. Their normal payments would have been monthly.

Q. (By Mr. Sherman): As a matter of fact, they would not issue their checks for the weekly payments until such a consent had been furnished to them, is that not correct?

A. We didn't try. They always requested it and we furnished it.

Q. Did they lead you to believe that they would require it before they would do it?

A. I think that would be a fair statement.

Mr. Sherman: No further questions, your [274] Honor.



MRS. IRENE HIGGINS

called as a witness by and on behalf of the defendant, having been first duly sworn, was examined and testified as follows:

The Clerk: State your name in full, please.

The Witness: Mrs. Irene Higgins.

The Clerk: Will you spell your last name?

The Witness: H-i-g-g-i-n-s.

The Clerk: Your address, please.

The Witness: 11331 Culver Drive in Culver City. [328]

Direct Examination

By Mr. Sherman:

Q. Mrs. Higgins, you were the bookkeeper for the White-Ahlgren Company, were you not?

A. Yes, sir; I was.

The Court: For what period?

The Witness: For the period from March of 1953 until August of 1954.

Q. (By Mr. Sherman): I take it then you were the bookkeeper for the company at the time that the Camp Pendleton job commenced?

A. Yes, sir; I was.

Q. At the time of the commencement of that job did you prepare weekly payroll sheets with respect to the payroll on that job?

A. Yes, sir; I did.

Q. Will you please tell us how those payroll sheets were prepared?

A. Yes, sir. The time cards were delivered to our San Diego office by the foremen, I would com-

(Testimony of Mrs. Irene Higgins.)

pute from the time cards the hours, rate of pay, withholding tax, the other deductions, the Federal and State deductions, and arrive at a net figure. I would do that for each timecard.

At the completion of that operation I would then transfer this information to a recap sheet indicating all the [329] men's names and the various categories, the Federal taxes, the State taxes, and their net pay.

Mr. Sherman: May I have Defendant's Exhibit W?

(The exhibit referred to was passed to counsel.)

Q. (By Mr. Sherman): Mrs. Higgins, I now hand you Defendant's Exhibit X in evidence——

Mr. Burford: Pardon me, just a minute. Could you move the microphone over just a little?

The Court: You cannot hear her?

Mr. Burford: No, your Honor.

Q. (By Mr. Sherman): Mrs. Higgins, is the Defendant's Exhibit X which you now have before you typical of the type of payroll recaps you prepared? A. Yes, sir; it is.

Q. What would you do with these payroll recaps after you prepared them?

A. These payroll recaps, the original was sent to Eva Cole's office in the very beginning, the carbon copy I kept as a file copy.

Q. What was your understanding as to the man-

(Testimony of Mrs. Irene Higgins.)

ner in which the payroll shown on the recap was to be paid?

A. In the beginning we were to receive an individual [330] check from Mrs. Cole for the gross payroll.

Q. By an individual check you mean one?

A. One check to cover the entire payroll.

Q. The payroll as shown on the recap for that week?

A. Yes.

Q. What was to then occur?

A. Then we were to prepare the individual checks on a payroll account.

Q. Did this procedure ever change?

A. Yes, sir; this procedure changed.

Q. When did it change?

A. On January 11th Mrs. Cole decided we should go back to net, we should adjust to net payroll rather than gross.

Q. How was the procedure varied in accordance with that?

A. The only change would be in the amount of the check issued by Mrs. Cole.

Q. And the amount of the check issued would be in the amount of net as shown on the recap rather than in the amount of the gross shown on the recap?

A. Yes.

Q. How long did that procedure continue?

A. Until around about the middle of March.

Q. What took place then?

A. Then it was decided that a representative from the bonding company, Century Indemnity,



(Testimony of Mrs. Irene Higgins.)

would come down to the [331] Pendleton construction shack and sign each individual check. No longer was one check made up for the entire payroll.

Q. You say each individual check. Upon what account were these individual checks drawn?

A. On the White-Ahlgren Trust Account No. 1.

Q. In what amount would the checks be made?

A. In the net amount.

Q. And The Century Indemnity representative would then be asked to countersign each of those checks drawn against the trust account in the net amount?

A. Yes, sir.

Q. How long did that procedure continue?

A. For the duration.

Q. Until the end of the job?

A. Yes.

Q. Who was The Century representative at the beginning of this procedure?

A. Mrs. Cole.

Q. Who were the other Century representatives?

A. There was also Mr. Van Tassel, Monte Waite—I believe that is all.

Q. That came down with reference to the countersigning of these checks?

A. Yes.

Q. When they would countersign these checks, would they use any source of reference to determine whether the checks [332] were proper or not?

A. I had previously prepared this recap sheet. The representative would take the recap sheet and compare it with the checks, check by check.

Q. Did you furnish such recap sheets to Mrs. Cole?

A. Yes.

Q. I want to make sure, you furnished such

(Testimony of Mrs. Irene Higgins.)

recap sheets to Mrs. Cole after this procedure of signing individual checks at the job site?

A. Yes.

Q. Had you furnished such payroll recaps to her prior to that time under the former procedure?

A. Yes.

Q. Did you at all times furnish the representative of Century Indemnity Company with a copy of the payroll recap? A. Yes.

The Court: Was there any other bank account of White-Ahlgren?

The Witness: White-Ahlgren had another bank account, yes, sir.

The Court: Throughout the time you were there?

The Witness: No, sir. It was closed, I would say, around about March of '54.

The Court: So White-Ahlgren Trust Account No. 1 was the only bank account they had?

The Witness: After March. [333]

The Court: After Mr. Van Tassel came on?

The Witness: I think that is right.

Q. (By Mr. Sherman): Mrs. Higgins, to clarify, there was in White-Ahlgren Trust Account No. 1 over which there was this countersignature requirement, is that correct? A. Yes.

Q. And in addition to that White-Ahlgren had their own account as to which no countersignature was required, is that correct?

A. That is true.

Q. To your knowledge, did White-Ahlgren have any other accounts which they alone controlled?

(Testimony of Mrs. Irene Higgins.)

A. No, sir.

Q. Now with reference to the disbursements from the trust account, did you ever have the bank statements for purposes of reconciling your books with the disbursements from the trust account?

A. At the very beginning I did not have. I did not receive December's or January's until the 1st of February. Thereafter I received them each month.

Q. From whom did you receive them each month?

A. I received the bank statements from the Century Indemnity office.

Q. At all times? [334]                      A. At all times.

Q. Throughout the entire continuation of the job?                      A. Yes, sir.

Q. Did you ever receive the bank statements directly from the bank?                      A. I did not.

Q. Now, Mrs. Higgins, directing your attention to on or about April 30, 1954, did you have occasion to discuss the payment of Federal withholding and employment taxes with Mr. Van Tassel?

A. Yes, sir.

Q. Would you please tell us what took place at that time?

A. On this date, April 30th, I presented to Mr. Van Tassel a check for both the Federal and the State payroll taxes for his signature.

Q. By "payroll taxes with reference to the Federal taxes," do you mean the withholding and the employment taxes?                      A. I do.



(Testimony of Mrs. Irene Higgins.)

Q. All right; please continue.

A. I presented this check or, rather, two checks, one to the State and one to the Federal government, for his signature along with the reports.

Q. You mean the returns?

A. The returns, yes. [335]

Mr. Van Tassel told me at that time to mail in the returns but that we would be in a better position later on to sign these checks.

Q. Did he at that time sign any checks?

A. The checks were not signed.

Q. Did he at that time indicate that if a check in a lesser amount were presented to him he would sign it?

A. No, sir.

Q. Did he say anything further to you at that time?

A. Not at that time.

Q. What did you then do?

A. I mailed the returns.

Q. Without payment?

A. Without payment.

Q. Did Mr. Van Tassel ever approve a check for payment thereafter?

A. A check was never cancelled. It was never signed.

Q. During the time——

The Court: May I interrupt you a moment?

Going back to this matter of bank statements, you said you didn't receive bank statements for December or January until February?

The Witness: Yes, sir.

The Court: And then you later stated that you

(Testimony of Mrs. Irene Higgins.)

received all statements from the office of Century Indemnity, including [336] those statements for December?

The Witness: Yes, sir.

The Court: So that you never received a bank statement of White-Ahlgren from the bank?

The Witness: That is correct.

The Court: Or cancelled checks?

The Witness: That is right. The cancelled checks go along with the statements.

The Court: In other words, all the cancelled checks and bank statements came to you from Century Indemnity?

The Witness: Yes, sir.

Q. (By Mr. Sherman): Now, Mrs. Higgins, at the time that you had this conversation with Mr. Van Tassel and thereafter were materialmen and suppliers being paid? A. Yes, sir.

Q. With reference to the suppliers, did you prepare any schedule or list of bills due to them?

A. Yes; at the beginning of the month of March and thereafter at the beginning of each month I would prepare a schedule of the accounts payable.

I would segregate these vendors by Pendleton and others, I would make a separate listing.

Q. Who told you to prepare such statements?

A. Mrs. Cole told me to prepare the first one, which [337] would have been the first of March, for the month of February.

Q. Did you just thereafter continue to prepare them that way?

(Testimony of Mrs. Irene Higgins.)

A. Thereafter Mr. Van Tassel would ask for the schedule.

The Court: That is the schedule of what now?

The Witness: Of accounts payable.

The Court: That is besides labor?

The Witness: Yes, sir.

Q. (By Mr. Sherman): To whom would you furnish these statements?

A. To the representative of the Century Indemnity who happened to be at the construction shack. In most cases it was Mr. Van Tassel.

Q. And Mrs. Cole as well?

A. The very first one, I believe, yes.

Mr. Sherman: No further questions, your Honor.

\* \* \*

### Cross-Examination

By Mr. Burford:

Q. Mrs. Higgins, I just want to ask you one simple question first.

You were the bookkeeper on this job and you have stated that these individual payroll checks were in the net [338] amount due?

A. Yes, sir.

Q. Have you ever seen a payroll check written to an employee which wasn't in the net amount due?

A. No, sir.

Q. I believe you said that this White-Ahlgren Company had another bank account, a general account, and your recollection was that it was closed



(Testimony of Mrs. Irene Higgins.)

around March of 1954?           A. Yes, sir.

Mr. Burford: I think that that is Defendant's Exhibit E.

(The exhibit referred to was passed to counsel.)

Q. (By Mr. Burford): Is this the account to which you refer?           A. Yes; it is.

Q. Do you want to look at it and see when it shows?

A. I realize now it was a smaller balance there but—I don't recall these entries.

Q. You don't recall whether this is the entire account?           A. No.

Q. I am not trying to confuse you—it is a long time ago—I just want to ask you if you want to correct your testimony?

A. Now that I see it, of course.

The Court: What is your testimony? [339]

The Witness: The account shows it was closed in August.

The Court: Let me see it.

(The exhibit referred to was passed to the Court.)

The Court: Were the checks to the materialmen or for other bills incurred other than labor drawn on the trust account as well as the payroll?

The Witness: I am sorry, sir.

The Court: You drew checks for labor and then you drew checks for materialmen and suppliers?

(Testimony of Mrs. Irene Higgins.)

The Witness: On this account?

The Court: No. I am going to ask which account were those checks for materialmen and suppliers drawn on?

The Witness: White-Ahlgren Trust Account.

The Court: All of them?

The Witness: Yes, sir.

The Court: Throughout your entire period with the company?

The Witness: Yes, sir.

The Court: What was their other account used for?

The Witness: During the month of December, January and February they were used for payroll from the Webb & Knapp job.

The Court: And after that?

The Witness: I don't recall.

The Court: There are several deposits here made in April, [340] \$618, \$1,700, \$1,100, and so forth. Do you remember what those were, the source of them?

The Witness: No.

The Court: Did you make them out?

The Witness: No; I wouldn't make out the deposits.

The Court: Very well.

Q. (By Mr. Burford): Mrs. Higgins, you testified that at the beginning a check was written to cover the gross amount of the payroll. That was in the beginning of the arrangement with Mrs. Cole, is that correct?           A. Yes; that is correct.

(Testimony of Mrs. Irene Higgins.)

Q. To whom was that check drawn?

A. I never saw the checks.

Q. Where was the check deposited?

A. I can tell from the statements it was deposited in the White-Ahlgren general account.

Q. That was the one that required no countersignature of the trustee?

A. The check drawn for the gross amount of the payroll was written on the White-Ahlgren trust account and did require a countersignature. It was deposited into the general account.

Q. Which did not?           A. Which did not.

Q. And that included those checks that first included [341] the withholding and Social Security and Federal unemployment tax?           A. Yes.

Q. So that they did go into that account?

A. Yes, sir.

Q. Reverting now to this April 30, 1954, discussion with Mr. Van Tassel about which you testified, do you know what the bank balance was on that date?           A. I do not know.

Q. If I showed you the books, could you refresh your recollection?

A. I doubt very much if the books would show it. The bank statement might.

Q. I am not asking what the bank statement showed; I am asking what the actual balance in the bank was at that date. Would the books show that?

A. Maybe my checkbook would. I did keep a running balance in the checkbook.

Q. Mrs. Higgins, I show you——



(Testimony of Mrs. Irene Higgins.)

Mr. Sherman: Your Honor, as a matter of procedure for the record, if counsel is showing the witness something I think it should be marked for identification.

The Court: Yes, indeed.

The Clerk: This will be No. 37.

(The document referred to was marked as Plaintiff's Exhibit No. 37 for [342] identification.)

The Court: What do you call this, a ledger, journal, check register?

Mr. Burford: I believe it is——

The Court: Let the witness tell us what it is.

Mr. Burford: Fine.

Q. How would you identify this Plaintiff's Exhibit 37 for identification, Mrs. Higgins?

A. This I would identify as the journal.

Mr. Sherman: Your Honor, since apparently counsel is going to refer to notations, may I accompany counsel?

The Court: Yes.

Q. (By Mr. Burford): Mrs. Higgins, I show you the page in the general ledger part of the journal referred to as the Trustee Bank Account. Now, would that be White-Ahlgren Trust Account No. 1?

A. Yes.

Q. Now it shows a balance as of certain dates, is that correct? A. Yes, sir.

Q. Can you state whether to your knowledge you knew whether these balance are correct?

(Testimony of Mrs. Irene Higgins.)

A. To the best of my knowledge, yes.

Q. Would you state for the Court what the balance is as shown to be as of April 30, 1954?

A. \$4,330.71. [343]

The Court: What was the amount?

The Witness: \$4,330.71.

The Court: What was it on March 30th?

The Witness: March 30th it was \$12,249.81.

Mr. Burford: Perhaps, your Honor, we should just go down the line on this to give you an idea of the running account.

Q. Would you state what the balance is shown to be on May 31, 1954?

A. \$12,000—I am sorry.

Q. You can give us both figures.

A. Here I have it straight.

It is an overdraft of \$5,901.75.

Q. Now just prior to that it had shown a balance of what? A. \$129,629.40.

Q. Then there is a payment of what?

A. \$135,531.15.

The Court: In one check?

The Witness: I don't think so, no, sir.

The Court: It just shows one entry?

The Witness: One entry.

Mr. Burford: This is a summary.

Mr. Sherman: This is a ledger, your Honor.

Q. (By Mr. Burford): Now, Mrs. Higgins, you testified that you prepared a [344] schedule of the payments due to suppliers under contract?

A. Yes, sir; I did.

(Testimony of Mrs. Irene Higgins.)

Q. How did you know what was due?

A. From the invoices and statements.

Q. They came to you?

A. They came to our San Diego office.

Q. Then you would schedule these?

A. Yes, sir.

Q. Did you always do it on a monthly basis?

A. Yes, sir.

Q. How did you know what was due in between these?

A. I did it once a month, the first of each month.

Q. Was everything paid once a month?

A. No, sir.

Q. How did you know what was owing on Friday, for example, when Mr. Van Tassel came down?

A. I kept a record of what was paid and how much of the account was paid, how much was paid on the account, so I would know at all times the status of the account.

Q. I believe you testified that when Mr. Van Tassel or another representative of Century came down that representative would inquire as to what was due?

A. Yes.

Q. Who would be present at those meetings?

A. Generally Mr. White. [345]

Q. And you?      A. And I, yes.

Q. Let's just take, for example, a supplier for the benefit of the court.

Suppose that you had an amount due for cement or crushed rock, how was that normally paid?



(Testimony of Mrs. Irene Higgins.)

A. The cement was normally paid by the 10th of the following month.

The Court: I think this might be an appropriate time for the recess.

(Short recess.)

The Court: Proceed.

Q. (By Mr. Burford): Mrs. Higgins, at the recess we had just started talking about these material bills.

Now you received these bills for the amount due for, say, mixed concrete or gravel.

Now did Mr. White ever see these bills?

A. I am sure he did.

Q. Did you ever hear any discussion in your presence between him and Mr. Van Tassel in regard to the payment of various bills?

A. Yes, but I can't specify any particular conversations. They did discuss them of course.

The Court: As to the general practice, who in White-Ahlgren [346] Company okayed a material bill for payment?

The Witness: Al White. I would first of all check the calculations——

The Court: Yes?

The Witness: ——to determine that they were accurate.

The Court: Yes?

The Witness: Then Al White would, when he paid or signed the check, would have before him the invoice and he would have the opportunity to check it.

(Testimony of Mrs. Irene Higgins.)

The Court: Who made the determination whether or not White-Ahlgren actually got the material?

The Witness: There would be a packing slip or a delivery slip signed at the time of delivery which I would match up with the invoice to determine that we did receive this.

The Court: Then your regular course of business, I am speaking of now, is that you would present these to Mr. White——

The Witness: Yes.

The Court: ——and he would approve them for payment?

The Witness: In most cases Mr. White, yes.

The Court: Who else?

The Witness: Mr. Ahlgren.

The Court: Mr. Ahlgren or Mr. White?

The Witness: Yes.

The Court: And then it was presented to Mr. Van Tassel? [347]

The Witness: Yes.

Q. (By Mr. Burford): Now, Mrs. Higgins, directing your attention—I know this is a long time ago and I am not trying to hold you to specific details at all—but do you recall at all the situation with respect to the amount due for mixed concrete about June and July of 1954?

A. No sir, not specific or outstanding.

Q. Do you know whether there were large balances due on or about that date?

A. No, sir, I do not know.

(Testimony of Mrs. Irene Higgins.)

Q. Do you recall whether the funds in the bank were ever sufficient during this time to pay all the bills that were due and outstanding at any one time?

Mr. Sherman: Your Honor, may I ask counsel to clarify what he means by "bank," since we have different accounts here.

Mr. Burford: I am referring to the White-Ahlgren Trust Account No. 1, Mrs. Higgins.

The Witness: Never at any time were there enough funds to pay all suppliers.

The Court: And labor?

The Witness: And labor.

The Court: And taxes?

The Witness: That is true, and taxes. [348]

Q. (By Mr. Burford): Now, Mrs. Higgins, reverting again to April 30, 1954, that is the date this check for payroll taxes was presented, you have testified, I believe, that the procedure was for the individual payroll checks to be paid after they were prepared by you and signed by Mr. White or Mr. Ahlgren and generally Mr. Van Tassel but some representative of The Century Indemnity Company, is that correct?      A. That is true.

Q. And that system didn't change on April 30th, that was the same system being followed then?

A. Yes.

Q. The same was true with respect to bills for suppliers about which you have just spoken?

A. Yes, sir.

Q. So on that date the usual procedure was fol-



(Testimony of Mrs. Irene Higgins.)

lowed, the payroll checks were presented and signed, the bills for suppliers were presented and signed?

A. Yes.

Q. And then this check for payroll taxes was presented? A. Yes, sir.

Q. Then refreshing your recollection, I believe you stated that the balance was around \$4300?

A. Yes, sir, that is true. Do you want the exact figure?

Q. You can give the exact figure. [349]

A. The book shows \$43,300.71.

Q. Can you testify that if that check had been signed there wouldn't have been sufficient funds in the bank for the check to clear?

A. That is true. The check was for more than that.

Mr. Burford: I have no further questions.

The Court: Very well.

### Redirect Examination

By Mr. Sherman:

Q. Mrs. Higgins, I would like to clarify one or two things. The procedure initially carried out with reference to payment of payroll, you said terminated, I believe, January 11th? That is when the new procedure of paying net instead of gross was initiated? A. Yes, sir.

Q. Would you please tell us when the system of paying gross was first started so that we could have our beginning and termination dates.

(Testimony of Mrs. Irene Higgins.)

A. December 18th, as I recall.

Q. So to briefly recapitulate, between December 18th and January 11th it was gross, between January 11th and the middle of March it was net, and from the middle of March until the end of the job it was individual checks against the trust account, is that correct? [350]      A. Yes, sir.

Q. Now you testified with reference to what the books show as to bank balance. In whose possession were those books?

A. These were in the San Diego office in my possession.

Q. Did Mr. Van Tassel ever ask to see those books?      A. Not that I recall.

Q. To the best of your recollection did Mr. Van Tassel ever consult that ledger with reference to what the bank balance was?

A. Not that I recall.

Q. Did you ever verify the balances that you carried in the ledger with what was shown on the bank statements after you received the bank statements?

A. No, sir.

Q. So whether or not, or the extent to which the books were in accord with the bank statements, that was not within your knowledge, is that correct?

A. That is true.

Q. Now, Mrs. Higgins, I believe you further testified that the suppliers were paid from the trust account?      A. Yes.

Q. What suppliers did you have reference to?

A. The suppliers for the Pendleton job.

(Testimony of Mrs. Irene Higgins.)

Q. To your knowledge were there any suppliers with [351] reference to other jobs at that time?

A. Not to my knowledge.

Q. The best you can recall, the suppliers were all paid from the trust account and they all pertained to the Pendleton job?                    A. True.

Q. Now with reference to which bills of suppliers would be paid and which suppliers would not, did Mr. Van Tassel ever personally direct you to pay any bill?

A. I recall a telephone conversation regarding Lee Steel.

Q. Would you tell us about it?

A. And he specified the amount he wanted to pay, and I am not sure——

The Court: Is Lee Steel a person or is that the name of a company?

The Witness: Lee Steel is the name of a company that furnished steel, as I recall.

Q. (By Mr. Sherman): Would you please continue.

A. And by telephone Mr. Van Tassel asked me to prepare this check, which I did, and mail it to him.

The Court: To whom?

The Witness: To Mr. Van Tassel. [352]

Q. (By Mr. Sherman): I believe you further testified as to the status per the books of the bank account, if there was sufficient funds to pay taxes. Is it not true that there was not sufficient funds because other types of items were preferred for payment?



(Testimony of Mrs. Irene Higgins.)

The Court: That is a leading question, Counsel, and I do not think it is proper redirect. I think you went into that matter on direct examination.

Mr. Sherman: Pardon me.

The Court: You went into that matter on the direct examination of this witness.

Mr. Sherman: I merely asked the witness——

The Court: You just want to nail it down a little.

Mr. Sherman: Well, I think that an inference exists in the record from the cross-examination that I would like the record to fairly portray.

Q. Let me ask you this question, Mrs. Higgins.

At the time that you presented this check to Mr. Van Tassel for taxes, which he didn't countersign, did he in any way indicate to you that you should prepare a check for the balance that was in existence and he would sign it?      A. No, sir. [353]

\* \* \*

### Cross-Examination

By Mr. Burford:

Q. Mrs. Higgins, you were the bookkeeper——

A. Yes, sir.

Q. ——and you stated that you never reconciled your books with the bank statement?

A. The public accountant did that.

Q. But you had the benefit of that information?

A. I could have had, yes, sir.

Q. Did you know what cash was actually in the bank at any particular time?

(Testimony of Mrs. Irene Higgins.)

A. Yes, I kept a running balance.

Q. You did keep a running balance?

A. Yes, sir.

Q. Did you ever yourself consult with Mr. Van Tassel in any way about his running balance or reconciling with him as to what was in the bank?

A. Each Friday we would reconcile with each other.

Q. So you did have a conference with respect to what was in the bank and what could be available for payments? A. Yes, sir.

Q. Now, Mrs. Higgins, would you recall about how much money was involved in these first gross payroll checks which went to the White-Ahlgren general account?

A. Will an estimate be sufficient? [354]

Q. If you can make a reasonable estimate. We are not trying to hold you to a particular amount. Would it be substantial?

A. There would be around \$10,000.

Q. Around \$10,000? A. Yes.

Q. That is your best estimate?

A. I think so.

Q. Now the payrolls which were represented by this \$10,000 were actually drawn on the trust account No. 1, were they not? A. Yes.

Q. So you had \$10,000 going out of Trust Account No. 1 in the White-Ahlgren general account and then another \$10,000 going out of the trust account for the same payroll? A. Yes, sir.

Mr. Burford: No further questions.

(Testimony of Mrs. Irene Higgins.)

Redirect Examination

By Mr. Sherman:

Q. Was it your understanding at that time that this was with the consent of Eva Cole?

A. Yes, sir.

Mr. Sherman: No further questions. [355]

\* \* \*

The Court: I would make a finding that there is no showing here that The Century Indemnity Company had the right and the power to go in and to hire any particular person or to fire a particular person, or to tell him where to pour the concrete, or when to pour it, or how to pour it, or what time to go to work or what time to come home. There is no evidence here to support any finding that they had any such authority.

Mr. Sherman: I don't when the Court says they had any such authority whether the Court means by law or by contract.

The Court: By law or by contract or in fact, from the evidence in the case.

Mr. Sherman: Do I understand the Court to be making a finding that they never exercised that control?

The Court: I am finding that they did not have that power in fact or by contract, and never exercised it, both. [396]

\* \* \*



The Court: Under the evidence I don't think Century Indemnity had any control of the job or the hiring or firing of anybody or of the doing of any work or the time of doing it.

Mr. Burford: There is no point in my pursuing that further then.

The Court: Or the manner of doing it or the method by which it should be done or when it should be started or completed. [408]

\* \* \*

## OPINION

I have listened with interest to the argument but I have indicated here that as a matter of fact from the evidence in the case it does not show that The Century Indemnity Company has any control of the persons employed, the manner or time or doing their work, when they started or when they finished, or of the purchase of any materials or from whom they should be purchased or how the work should be done, or when it should be done or the manner in which it should be performed. For that reason I do not think that they come within the definition of 1426 of the 1939 Code where the tax is due by an employer where the common-law relationship of an employer and employee exists, and for that reason judgment will be for the plaintiff on Counts 2 and 3.

On Count 1, I think the taxes that were due to March 18th come clearly within the Simpson case and the [411] Fireman's Fund case, within the facts of those cases. The facts here are the same and are

controlled by those cases. The plaintiff will have judgment for the return of whatever sum of money the taxes were to March 18th on the first count of the indictment.

But as to the balance of this money due under the first count of the indictment, this is controlled by the definition set forth in 1621(d), and I am satisfied from all of the evidence that while there was a joint control, it was a control which is equal to the veto power, about which we have learned a great deal lately, and therefore is a control, and that means The Century Indemnity Company had control within the terms and provisions of Section 1621(d) of the payment of the wages to the employees after March 18th insofar as the taxes are concerned in Count 1, and judgment will be for the defendant as to that sum of money.

I have not been able to calculate it, but I merely announce my decision so you will prepare your findings of fact and conclusions of law accordingly.

I do not think there is any other issue to be found on it.

\* \* \*

[Endorsed]: Filed January 13, 1961.

---

[Title of District Court and Cause.]

#### CERTIFICATE BY THE CLERK

I, John A. Childress, Clerk of the above-entitled Court, hereby certify that the foregoing documents

together with the other items, all of which are listed below, constitute the transcript of record on appeal to the United States Court of Appeals for the Ninth Circuit, in the above-entitled case:

Names and Addresses of Attorneys.

Complaint, filed 10/7/58.

Summons, dated 10/7/58.

Answer, filed 12/8/58.

Notice of Motion and Motion of Plaintiff for discovery, filed 3/5/59.

Affidavit of Arthur H. Deibert, filed 3/13/59.

Minute Order 3/26/59 re hearing on motion for discovery.

Opposition by Defendant to Plaintiff's Motion for discovery under F.R.C.P. 34, filed 3/31/59.

Reply to opposition by Defendant to Plaintiff's motion for discovery under F.R.C.P. 34, filed 4/7/59.

Minute Order 4/8/59 re hearing on motion plaintiff for discovery.

Order granting Petitioner's motion for discovery under F.R.C.P. 34, filed 4/10/59.

Notice of Appearance of Burton A. Van Tassel, as co-counsel, filed 5/8/59.

Plaintiff's Memorandum of Contentions of Fact and Law, filed 9/25/59.

Defendant's Memorandum of Contentions of Fact and Law, filed 10/5/59.

Pretrial Conference Order, filed 10/5/59.

Minute Order 10/5/59 re setting for trial.

Minute Order 11/30/59 re setting for trial.



Plaintiff's Trial Memorandum, filed 9/9/60.

Amended and Supplemental Pre-Trial Conference Order, filed 9/13/60.

Minute Order 9/13/60 re setting for trial.

Minute Order 9/20/60 re trial.

Minute Order 9/21/60 re further trial.

Minute Order 9/27/60 re further trial.

Minute Order 10/4/60 re further trial.

Minute Order 10/5/60 re further trial.

Defendant's objections to Plaintiff's proposed Findings of Fact, Conclusions of Law and Judgment, filed 11/10/60.

Stipulation and Order extending Defendant's time to file objections, filed 11/9/60.

Defendant's proposed Findings of Fact, Conclusions of Law and Judgment, lodged 11/10/60.

Stipulation and Order extending Plaintiff's time to file reply to Defendant's objections, filed 11/14/60.

Plaintiff's reply to Defendant's objections to Plaintiff's proposed Findings of Fact, Conclusions of Law and Judgment, filed 11/17/60.

Request for oral hearing on Findings of Fact and Order thereon, filed 11/22/60.

Minute Order 12/5/60 re hearing on objections to proposed findings, etc.

Certificate of Probable Cause, filed 12/5/60.

Findings of Fact, Conclusions of Law and Judgment, filed 12/5/60, entered 12/6/60.

(Copy) Clerk's notice of entry of judgment, dated 12/6/60.

Plaintiff's Bill of Costs, filed 12/7/60.

Objections to Plaintiff's Bill of Costs.

(Copy) Letter of December 30, 1960, retaxing of costs.

Motion to re-tax costs and request for oral hearing thereon, filed 1/4/61.

Defendant's Points and Authorities in opposition to Plaintiff's motion to re-tax costs, filed 1/12/61.

Minute Order 1/16/61 re hearing on motion to re-tax costs.

Order re-taxing costs, filed 1/18/61.

Notice of Appeal filed by Plaintiff, filed 2/2/61.

Notice of Cross Appeal filed by Defendant 2/3/61.

Defendant's motion for extension of time to docket cause on cross-appeal and order, filed 2/24/61.

Plaintiff's motion for extension of time to docket cause on appeal and order, filed 3/9/61.

Appellant's Designation of record, filed 4/21/61.

Statement of Points Appellant the Century Indemnity Company intends to rely on on appeal, filed 4/21/61.

Designation of contents of record on cross-appeal, filed 4/25/61.

Three volumes of Reporter's Transcript of proceedings had on:

Sept. 20 and 21, 1960 (excerpts of testimony of certain witnesses) (Pages 1 to 62).

Sept. 20 and 21, 1960 (Trial proceedings).

October 4 and 5, 1960 (Trial proceedings).

Plaintiff's Exhibits: 1 (Pretrial order), 1-A (Amended and supplemental pretrial order), 2, 3,

4-A, 4-B, 4-C, 4-D, 5, 10, 12, 13, 14, 15, 16, 20, 24, 25, 27, 28, 29, 30, 31, 36 and 37.

Defendant's Exhibits: A, B, C, D, E, F, G, H, I, J, U, V, W, X, Y, Z, AB, AC, AD, AE.

Dated: April 28, 1961.

[Seal]                      JOHN A. CHILDRESS,  
Clerk.

By /s/ WM. A. WHITE,  
Deputy Clerk.

---

[Endorsed]: No. 17354. United States Court of Appeals for the Ninth Circuit. Century Indemnity Company, Appellant, vs. Robert A. Riddell, etc., Appellee, and Robert A. Riddell, etc., Appellant, vs. Century Investment Co., Appellee. Transcript of Record. Appeals from the United States District Court for the Southern District of California, Central Division.

Filed April 29, 1961.

Docketed May 8, 1961.

/s/ FRANK H. SCHMID,  
Clerk of the United States Court of Appeals for the  
Ninth Circuit.



In the United States Court of Appeals  
for the Ninth Circuit

No. 17354

THE CENTURY INDEMNITY COMPANY, a  
Corporation,

Plaintiff-Appellant,

vs.

ROBERT A. RIDDELL, District Director of In-  
ternal Revenue for the Los Angeles District of  
California,

Defendant-Appellee.

STIPULATION AND ORDER RE  
ABBREVIATION OF THE PRINTED RECORD

It Is Hereby Stipulated by and between the parties hereto, through their respective counsel of record, because of the voluminous exhibits offered and introduced into evidence in the Court below, and in order to abbreviate the scope and economize the costs of the printed record, that all the exhibits may be considered in their original form by the Court and counsel in their briefs and oral argument and need not be printed; subject to the right of either party to designate for printing any portion of said exhibits.

Dated: May 15, 1961.

DEMPSEY, THAYER,  
DEIBERT & KUMLER,

By /s/ ARTHUR H. DEIBERT,  
Attorneys for Appellant.

FRANCIS C. WHELAN,  
United States Attorney;

ROBERT H. WYSHAK,  
Assistant U. S. Attorney,  
Chief, Tax Division;

By /s/ EUGENE N. SHERMAN,  
Attorneys for Appellee.

### ORDER

It Is So Ordered this 23rd day of May, 1961.

/s/ STANLEY N. BARNES,  
United States Circuit Judge.

[Endorsed]: Filed May 25, 1961.

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[Title of Court of Appeals and Cause.]

### STIPULATION AND ORDER FOR CORREC- TION OF REPORTER'S TRANSCRIPT OF PROCEEDINGS

It Is Hereby Stipulated by and between the parties hereto, through their counsel of record, that the word "White-" be inserted after the word "meaning" and before the word "Ahlgren" on page 184, line 7, of the official reporter's transcript of proceedings for September 21, 1960, so that said line reads as follows:

"meaning White-Ahlgren"

and that the printing of said reporter's transcript contain this correction.

Dated: May 31, 1961.

DEMPSEY, THAYER,  
DEIBERT & KUMLER,

By /s/ ARTHUR H. DEIBERT,  
Attorneys for Appellant-  
Cross-Appellee.

FRANCIS C. WHELAN,  
United States Attorney;

ROBERT H. WYSHAK,  
Assistant U. S. Attorney,  
Chief, Tax Division;

EUGENE N. SHERMAN,  
Assistant U. S. Attorney;

/s/ EUGENE N. SHERMAN,  
Attorneys for Appellee-  
Cross-Appellant.

### ORDER

Good Cause Appearing Therefor, it is so ordered  
this 6th day of June, 1961.

/s/ O. D. HAMLIN,  
United States Circuit Judge;



/s/ FREDERICK G. HAMLEY,

United States Circuit Judge;

/s/ RICHARD H. CHAMBERS,

United States Circuit Judge.

[Endorsed]: Filed June 7, 1961.

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[Title of Court of Appeals and Cause.]

AMENDED STATEMENT OF POINTS UPON  
WHICH CROSS-APPELLANT INTENDS  
TO RELY ON CROSS-APPEAL

Cross-appellant, Robert A. Riddell, hereby amends the Statement of Points Upon Which Cross-Appellant Intends to Rely on Cross-Appeal, previously filed herein, and pursuant to the provisions of Rule 17(6) of the Rules of this Court, designates only the following as the points upon which cross-appellant intends to rely on cross-appeal:

1. The Trial Court erred in finding that plaintiff did not have control of the payment of the wages of the employees of White-Ahlgren Company, Inc., for the services rendered by said employees between December 7, 1953, and March 8, 1954.

2. The Trial Court erred in failing to find that plaintiff required the opening of the "White-Ahlgren Trust Account No. 1" as a condition precedent

to its issuance of the surety bond, described as contract bond No. 291379.

3. The Trial Court erred in concluding that plaintiff was not the "employer" of the employees of White-Ahlgren Company, Inc., for the period between December 7, 1953, and March 8, 1954, within the meaning of Secs. 1621(d), 1622(a) and 1623 of the Internal Revenue Code of 1939, as amended.

4. The Trial Court erred in concluding that plaintiff is not liable to defendant for the payment of the Withholding taxes for the period between December 7, 1953, and March 8, 1954, required to be deducted, withheld and paid by said Secs. 1622 (a) and 1623 and is entitled to judgment against defendant for refund of the taxes, delinquency penalty and interest so paid for said period.

5. The Trial Court erred in decreeing judgment for plaintiff against defendant for refund of Withholding taxes, delinquency penalty and interest for the period between December 7, 1953, and March 8, 1954, paid by plaintiff to defendant.

6. The Trial Court erred in ordering the retaxing of plaintiff's costs of suit, and in decreeing judgment for plaintiff against defendant for said costs in the following particulars:

(a) Fees of the Clerk.....	\$15.00
(b) Fees of the Marshal.....	5.50

- (c) Fees of the Court Reporter for all or any part of the transcript necessarily obtained for use in the case..... 77.50
- (d) Docket fees under 28 U.S.C. 1923..... 27.50
- (e) Costs incident to taking of depositions.. 55.80

Dated: June 13, 1961.

FRANCIS C. WHELAN,  
U. S. Attorney;

ROBERT H. WYSHAK,  
Asst. U. S. Attorney, Chief,  
Tax Division;

EUGENE N. SHERMAN,  
Asst. U. S. Attorney;

/s/ EUGENE N. SHERMAN,  
Attorneys for Appellee and Cross-Appellant, Robert A. Riddell.

[Endorsed]: Filed June 15, 1961.



No. 17358.

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

MAURIE W. STARRELS and DORIS W. STARRELS,  
*Petitioners,*  
*vs.*

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

---

Petition to Review a Decision of the Tax Court of the  
United States.

---

PETITIONERS' OPENING BRIEF.

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KENNY, MORRIS & IBANEZ,  
1557 Beverly Boulevard,  
Los Angeles 26, California,  
*Attorneys for Petitioners.*



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No. 17358.

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

MAURIE W. STARRELS and DORIS W. STARRELS,  
*Petitioners,*

*vs.*

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

---

Petition to Review a Decision of the Tax Court of the  
United States.

---

## PETITIONERS' OPENING BRIEF.

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### Statement of Facts.

A stipulation of facts executed by the parties [Tr. 11-13] recited that the petitioner Doris W. Starrels was the daughter of the late Commander Frank W. Wead, U.S.N. [pars. 1, 2]; that Loew's, Inc., desired to produce a motion picture concerning naval aviation, and ultimately did produce and market such a picture [par. 3]; that Loew's, Inc., intended the photoplay to be "based on, adapted from, or using as a springboard the life story" of Commander Wead [par. 4]; that

Loew's, Inc., entered into an agreement with the petitioner on November 9, 1954, contained in two documents, styled an "option" and a "consent". Attached thereto as Exhibits were the option agreement 3-C and the consent 4-D [par. 6]; that in 1956, Loew's, Inc., produced and distributed throughout the United States a feature motion picture in which was depicted events taken from the life of Commander Wead [par. 7]; and that pursuant to the contract of November 9, 1954, Loew's, Inc., paid \$5,800.00 to the petitioner in 1956 [par. 8].

On January 26, 1961, the Tax Court filed its opinion [Tr. 14-19] deciding that there was a deficiency in income tax for the year 1956 in the amount of \$1,-530.87 resulting from the \$5,800 payment by Loew's, Inc. to petitioner.

### **Specifications of Error.**

The Tax Court erred as follows:

1. In holding that the money received from Loew's was taxable income on the stated ground of absence of evidence that the motion picture, in fact, injured or damaged the payee by an invasion of her right of privacy or in any other way [Assignment of Error No. 1, Tr. 22].
2. In failing to rule upon petitioners' contention that, unlike libel and slander, the gist of the action in privacy cases is not injury to the character or reputation, and that an invasion of privacy occurs without re-



gard to any effect which the publication may have on the standing of the individual in the community [Assignment of Error No. 2, Tr. 22-23].

### Question Presented.

The taxpayer has received from the producer of a motion picture depicting events in the life of her deceased father a sum of money as consideration for her agreement not to claim any violation of her personal right of privacy by reason of the production and exhibition of the film. The film has been produced and widely exhibited. Is this money properly includible in her gross income under 26 U. S. C. 104(a)(2) which excludes "the amount of any damages received (whether by suit or agreement) on account of personal injuries"?

## ARGUMENT.

### I.

#### The Tax Court Erred in Holding That There Was No Showing of an Injury to Taxpayer's Personal Right of Privacy.

Although the decision below recognized that in 1956, Loew's, Inc. had produced and distributed through the United States a motion picture which depicted events taken from the life of the taxpayer's father [Tr. 16], the Tax Court held that taxpayer's personal right of privacy "was never invaded and possibly never intended to be invaded" [Tr. 18] and that no valid claim for exclusion may be made "without some showing of an injury which has been sustained" [Tr. 19].

Petitioners respectfully submit that the production and distribution of such a motion picture constituted *per se* an injury to taxpayer's privacy. The Tax Court erred, it is submitted, when it equated an invasion of privacy with an injury by defamation.

The Supreme Court of California has ruled contrary to the Tax Court. In *Curtis v. Gill* (1952), 38 Cal. 2d 273, 239 Pac. 630, it said at p. 281:

"Plaintiffs do not allege that their right of privacy was invaded or that they suffered mental distress, assert defendants, and thus no cause of action is stated. Plainly the complaint alleges facts which clearly show a violation of plaintiffs' right of privacy. More is not necessary."

The California court cited the Restatement of Torts as follows (p. 280):

"867. A person who unreasonably and seriously interferes with another's interest in not having his

affairs known to others or his likeness exhibited to the public is liable to the other.”

“The right of privacy concerns one’s own peace of mind, while the right of freedom from defamation concerns primarily one’s reputation.” 41 Am. Jur. 925 (Fn. 15), 138 A.L.R. 25. “Unlike libel and slander, the gist of the cause in privacy cases is not injury to the character or reputation, but direct wrongs of a personal character resulting in injury to the feelings, without regard to any effect which the publication may have on the standing of the individual in the community.” 41 Am. Jur. p. 925 (Fn. 15.5 Cum. Supp.).

Petitioners submit that public exhibition for commercial purposes of one’s family life is *ipso facto* an invasion of the personal right of privacy, no matter how well-intentioned, and that the parties may contract for reparation of such a planned invasion of property by fixing in advance a sum which liquidates such damage and fixes a ceiling for its recovery.

## II.

### **The Four Decisions Relied Upon by the Tax Court [Tr. 17] Are Not Applicable to the Instant Case.**

*Damon Runyon, Jr. v. U. S.* (C. A. 5, 1960), 281 F. 2d 590, as the Tax Court pointed out [Tr. 17, fn. 1], involved the rights of the deceased father, not the taxpayer himself. In California, as in New York, one cannot recover as an heir, the right being limited to a person (like the petitioner here) whose own privacy was invaded (*Metter v. L. A. Examiner* (1939), 35 Cal. App. 2d 304, 310, 95 P. 2d 491).



*Helen D. Miller* (1961), 35 T. C. No. 68, involved a claimed sale of a capital asset (the right to use the name, likeness and good will attached to the late Glenn Miller) to which the release of the widow's rights of privacy was merely incidental [Tr. 17, fn. 1].

In *Erlich v. Higgins*, (S.D. N.Y., 1943), 52 Fed. Supp. 805 and *Meyer v. U. S.* (E.D. Tenn., 1959), 173 Fed. Supp. 920, both District Courts bottomed their decisions on the fact nothing "libelous, slanderous or defamatory" was actually published and therefore no wrong had been done. Under petitioner's argument in Point I, *supra*, this factor is legally irrelevant on the question of whether there was an invasion of the right of privacy.

### III.

#### **Compensation for the Invasion of Personal Rights by Defamation, Alienation of Affections, Breach of Promise to Marry or Change of Child Custody Has Long Been Treated as Not Taxable.**

As early as 1922, the Solicitor of Internal Revenue (Sol. Op. 132, Cum. Bull. I-1, p. 92.93 [1922]), declared that:

"In *Stratton's Independence v. Howbert*, 231 U. S. 399 and in *Eisner v. Macomber*, 252 U. S. 189, 207, the Supreme Court defined income as 'the gain derived from capital, from labor, or from both combined'. . . .

"In the light of these decisions of the Supreme Court it must be held that there is no gain, and therefore no income, derived from the receipt of damages for *alienation of affections or defamation*

*of personal character. . . .* If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market value, and thereafter receives either damages or payment in compromise for an invasion of that right, it cannot be held that he thereby derives any gain or profit. It is clear, therefore, that the Government cannot tax him on any portion of the sum received.” (Emphasis supplied.)

*C. A. Hawkins v. Commissioner* (1927), 6 B. T. A. 1023 held that a \$100,000 settlement for personal *defamation* was not taxable.

*Lyle McDonald v. Commissioner* (1928), 9 B. T. A. 1340 held that money paid as settlement for a claim of *breach of promise to marry* was not includible in gross income.

This line of decision has been the subject of favorable scholarly comment:

“There is a class of compensatory recoveries no part of which is taxes as income, since no cost basis can be assigned to the injury which is sustained. Most important of these are recoveries on account of personal injuries. This is now expressly provided for by statute [now I.R.C. of 1954, 26 U. S. C. 104(a)(2)], but the same rule had previously been followed. In the same category, although not covered by the statutory exception, are recoveries for libel and slander, for alienation of affections, or for breach of promise to marry, and sums received in settlement of child custody suit. For the human body and the reputation which are injured are in no true sence capital or property upon which a value can be placed for

the purpose of computing the profit realized; the promise to marry likewise is a personal right not susceptible of appraisal in relation to market values; and the spouse whose affections are alienated and the child whose custody is surrendered are not chattels which are sold.”

Plumb “Income Taxes on Gains and Losses in Litigation” (1938), 25 Cornell L.D. 221, 234.

See also:

Cutler “Taxation of the Proceeds of Litigation” (1957), 57 Col. L. Rev. 470, 471 fn. 5.

### **Conclusion.**

The decision of the Tax Court should be reversed.

Respectfully submitted,

KENNY, MORRIS & IBANEZ,

By ROBERT W. KENNY,

*Attorneys for Petitioners.*



**In the United States Court of Appeals  
for the Ninth Circuit**

---

**MAURIE STARRELS and DORIS W. STARRELS,  
PETITIONERS**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

---

**On Petition for Review of the Decision of the  
Tax Court of the United States**

---

**BRIEF FOR THE RESPONDENT**

---

**LOUIS F. OBERDORFER,**  
*Assistant Attorney General.*

**LEE A. JACKSON,  
HAROLD M. SEIDEL,**  
*Attorneys,  
Department of Justice,  
Washington 25, D. C.*

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 17,358

**MAURIE STARRELS and DORIS W. STARRELS,  
PETITIONERS**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

---

**On Petition for Review of the Decision of the  
Tax Court of the United States**

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**BRIEF FOR THE RESPONDENT**

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**OPINION BELOW**

The Tax Court's opinion (R. 14-19) is reported at 35 T.C. 646.

**JURISDICTION**

This petition for review (R. 20-23) involves federal income taxes for the calendar year 1956. On July 14, 1958 (R. 3) the Commissioner of Internal Revenue mailed to the taxpayers notice of a deficiency in the total amount of \$1,530.87 (R. 6-9). Within

ninety days thereafter and on October 2, 1958, the taxpayers filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954. (R. 3-9.) The decision of the Tax Court was entered on January 27, 1961. (R. 19.) The case is brought to this Court by petition for review filed March 23, 1961. (R. 20-23.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

### QUESTION PRESENTED

The taxpayer<sup>1</sup> entered into an agreement with a motion picture studio permitting and helping it to make a motion picture dealing with her deceased father's life. Did the Tax Court correctly hold that the amount received by taxpayer under the contract was includible in her gross income?

### STATUTE INVOLVED

Internal Revenue Code of 1954:

#### SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.*—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

\* \* \* \*

(26 U.S.C. 1958 ed., Sec. 61.)

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<sup>1</sup> Doris W. Starrels will be hereafter referred to as the taxpayer. Maurie Starrels is a party to these proceedings only because he filed a joint tax return with his wife. (R. 12.)



SEC. 104. COMPENSATION FOR INJURIES OR SICKNESS.

(a) *In General.* — Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness;

\* \* \* \*

(26 U.S.C. 1958 ed., Sec. 104.)

STATEMENT

All of the facts in this case were stipulated (R. 11-13, 14) and may be summarized as follows:<sup>2</sup>

The taxpayer and her sister, Lila Berman, are the daughters and only issue of the late Commander Frank W. Wead, U.S.N. (R. 14.)

Loew's, Inc., desired to produce a motion picture concerning naval aviation and ultimately did produce and market such a picture. It intended the photoplay to be "based on, adapted from, or using as a spring-board the life story" of Commander Wead. (R. 15.)

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<sup>2</sup> Attached to and incorporated in the Stipulation of Facts were certain exhibits. (R. 11-13.) This Court has approved a stipulation between the parties to the effect that the exhibits need not be included in the printed record but that the parties and the Court may refer to and consider them as if they were in that record. (R. 25.)

In 1954, in furtherance of this purpose, Loew's purchased from the Beverly Hills National Bank and Trust Company, trustee under the will of Commander Wead, the literary material entitled "We Plaster the Japs" which was written by Commander Wead and published in the September, 1944, issue of American Magazine. (R. 15.)

Loew's also entered into an agreement with taxpayer and her sister on November 9, 1954, which consisted of two documents: a letter from Loew's to the sisters referred to as an option and a letter from the sisters to Loew's referred to as a release. Among other things, the terms of the agreement provided:

(a) The sisters agreed to permit Loew's to produce, release, distribute, and exhibit a motion picture based on the life of their late father, Commander Wead. (R. 15.)

(b) They agreed to permit Loew's to depict their deceased father, themselves, and other members of their family in the photoplay and in the advertising and publicity thereof and to use actual names or fictitious names for themselves and other members of their family, and to use actual and wholly and partially fictitious incidents. (R. 15; Ex. 3-C.)

(c) The sisters promised that at no time would they claim or assert that the photoplay or any matter therein contained or any use made by Loew's of the names, likenesses, pictures, or characterizations of their father, themselves, or other members of their family under the agreement constituted a violation



of any of their rights including their rights of privacy. (R. 15-16.)

(d) They agreed to deliver to Loew's such material in the way of photographs, letters, family documents, facts, or other material or information and suggestions which were available and which could be helpful in the preparation of the motion picture. (R. 16.)

(e) The sisters agreed that during the life of the agreement they would not authorize others to produce or exhibit any motion picture photoplay nor would they consent to the portrayal, depiction, or impersonation of their father or of themselves in any other motion picture. (R. 16.)

(f) Loew's was further granted the right to advertise, promote, and exploit the photoplay by all means customarily used in the trade. (R. 16.)

(g) The sisters were to receive jointly a sum of \$2,400 upon the execution of the agreement and were to be paid further sums upon the happening of specified events and/or upon the satisfaction of certain conditions. (R. 16.)

(h) They agreed to use their best efforts to assist the bank and its agent in obtaining approval and the necessary signatures for its (the bank's) sale to Loew's of "We Plaster the Japs". (Ex. 4-D.)

(i) Lastly, the sisters granted Loew's copyright renewals to "We Plaster the Japs", and appointed Loew's their attorney in fact to execute all documents necessary to obtain extensions and renewals of the copyright. (Ex. 4-D.)



In 1956 Loew's produced and distributed throughout the United States a feature motion picture entitled "The Wings of Eagles" which depicted events taken from the life of Commander Wead. (R. 16.)

Pursuant to the agreement of November 9, 1954, Loews paid taxpayer the sum of \$5,800 in 1956. On her joint income tax return, she noted this receipt as "payment for invasion of personal family rights—not included as taxable income". The Commissioner in his deficiency notice determined that the entire amount of the receipt from Loew's should have been included in taxable income. (R. 16-17.) The Tax Court sustained the Commissioner (R. 19) and the taxpayer takes this appeal.

#### SUMMARY OF ARGUMENT

The taxpayer received an amount, in part, as consideration for release of her right to privacy. The sum is taxable to her as consideration for the contractual release of a legal right. Taxpayer realized a gain or increment from receipt thereof, and by voluntarily releasing her right to privacy taxpayer precluded injury from any action taken on the basis of the release. An analogous situation from the tax point of view is the consideration received for a covenant not to compete, which is taxable as ordinary income.

The consideration received for waiving the right to privacy is treated for tax purposes differently from amounts received as damages for a tortious invasion of that right. In the former situation there cannot be any injury by virtue of the consent, and the con-

sideration for surrendering the right is gain to the recipient. In the latter case, the damages make the injured party whole for the loss of his personal rights and the restitution is therefore not taxable income, but, in a sense, return of capital.

However, assuming *arguendo* that the amount received for surrender of the right to privacy is to be treated in the same manner as damages for a tortious violation of the right, taxpayer nevertheless cannot prevail here because the record is devoid of evidence showing that she actually suffered any invasion of her privacy by reason of the production and distribution of the picture. In the absence of such evidence, the amount received did not make her whole but was gain to her.

Taxpayer's argument that the motion picture depicting events in her father's life was damaging to her privacy fails to recognize that there is no evidence that she was even mentioned in the picture and that she has, under California law, no right to privacy in her father's life.

Although taxpayer only indirectly appears to rely on the exclusionary provisions of Section 104(a)(2) of the 1954 Internal Revenue Code, the section is inapplicable because its terms are not met here and because the legislative history of the section indicates that it was not intended to apply to situations such as the taxpayer's.



## ARGUMENT

**The Tax Court Correctly Held That the Amount Taxpayer Received Under the Agreement With Loew's Relating to the Production of a Motion Picture About Her Father's Life Was Taxable Income to Her**

Pursuant to an agreement entered into by Loew's with taxpayer and her sister granting Loew's permission to make a film (R. 12) "based on, adapted from, or using as a springboard the life story" of taxpayer's father, taxpayer received \$5,800 in 1956 (R. 16). The agreement contained a number of other provisions in one of which taxpayer consented to be portrayed in the picture and in the advertising for the picture. In another provision, taxpayer agreed that she would at no time claim that the picture constituted a violation of her privacy. Taxpayer apparently argues that the \$5,800 was received solely for release of her right to privacy and that that sum is excludable from her gross income.<sup>3</sup>

It is well-settled that under California law the taxpayer has a right to her own privacy which includes the "right to be let alone", to be protected from unwarranted and undesired publicity. The right to privacy is independent of rights of property, contract, reputation and physical integrity. The injury is mental and subjective and depends on whether the actor should have known that the act would offend the sen-

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<sup>3</sup> As the Tax Court noted (R. 17) taxpayer does not contend in the alternative that there has been a sale or exchange of a capital asset entitling her to report the amount realized as capital gain. Cf. *Runyon v. United States*, 281 F. 2d 590 (C.A. 5th).



sibilities of a normal person. *Gill v. Hearst Publishing Co.*, 40 Cal. 2d 224, 253 P. 2d 441; *Gill v. Curtis Publishing Co.*, 38 Cal. 2d 273, 239 P. 2d 630; *Fairfield v. American Photocopy Etc. Co.*, 138 Cal. App. 2d 82, 291 P. 2d 194; *Melvin v. Reid*, 112 Cal. App. 285, 297 Pac. 91. The right to privacy is different from the "right to publicity" which does exist in California (*Strickler v. National Broadcasting Co.*, 167 F. Supp. 68 (S.D. Cal.)); since the right to privacy is personal and does not survive the person involved, taxpayer had no right to privacy in her father's life (*Kelly v. Johnson Publishing Co.*, 160 Cal. App. 2d 718, 325 P. 2d 659; *James v. Screen Gems, Inc.*, 174 Cal. App. 2d 650, 344 P. 2d 799).

The release or waiver of a legal right extinguishes that right and permits the person to whom the waiver runs to do certain acts which the law otherwise prohibits and for which it grants a cause of action. Thus, taxpayer by releasing her right to privacy to Loew's and permitting it to portray her in the motion picture in effect extinguished that right with respect to that picture. She consented to an invasion of her privacy by the picture (within the scope of the release), an invasion which never occurred. Because the gravamen of the right to privacy is freedom from unwarranted publicity, the waiver of the right (or the consent to the publicity) precludes any damage and negates any injury.

As the late Judge Fee pointed out in *Ehrlich v. Higgins*, 52 F. Supp. 805, 809 (S.D. N.Y.), the income tax consequences of being compensated for a contractual surrender of the legal right to privacy are

that the amounts received are taxable as ordinary income as, for example, are amounts received for surrendering the legal right to compete in business.<sup>4</sup>

Section 61(a) of the Internal Revenue Code of 1954, *supra*, provides that "gross income means all income from whatever source derived." The Supreme Court has held that this language was used by Congress to exert its full constitutional power to tax incomes, and that any increment or gain received by a taxpayer (not expressly excepted by the statute) is therefore subject to tax. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429; *Helvering v. Clifford*, 309 U.S. 331, 334; *Douglas v. Willcuts*, 296 U.S. 1, 9. In *Glenshaw Glass Co.*, *supra*, the Court sustained on that ground the inclusion in income of punitive damages awarded the taxpayer in an anti-trust suit, despite the fact that the damages were not derived from capital, or labor, or both combined. In that case it stated (pp. 429-430) that:

This Court has frequently stated that this language was used by Congress to exert in this field "the full measure of its taxing power." *Helvering v. Clifford*, 309 U.S. 331, 334; *Helvering v. Midland Mutual Life Ins. Co.*, 300 U.S. 216, 223; *Douglas v. Willcuts*, 296 U.S. 1, 9; *Irwin v. Gavit*, 268 U.S. 161, 166. \* \* \* Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal con-

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<sup>4</sup> *Yost v. Commissioner*, 155 F. 2d 121 (C.A. 9th); *Beal's Estate v. Commissioner*, 82 F. 2d 268 (C.A. 2d); *Salvage v. Commissioner*, 76 F. 2d 112 (C.A. 2d), affirmed, 297 U.S. 106.



struction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. \* \* \*

See also *Gen. Investors Co. v. Commissioner*, 348 U.S. 434.

The amounts received for the contractual surrender of a legal right therefore are taxable because they result in increment or gain to the recipient.

Taxpayer apparently contends that since amounts received as compensation for tortious conduct are excludable from income the \$5,800 that she received for surrendering her right to privacy is similarly excludable. This argument fails to distinguish between the voluntary release of a right to privacy and an involuntary tortious loss of that personal right. As stated above, by surrendering her legal right, taxpayer has permitted certain conduct and has acknowledged that she will not be injured thereby and that the publicity will not offend her sensibilities.

However, in the case of a tortious invasion of privacy or loss of other personal rights, there is an involuntary loss of the right involved. The exclusion of damages for tortious conduct is predicated on the ground that the damages restored the recipient to his status prior to the tortious conduct suffered, i.e., that the damages are an attempt to make the recipient whole by restitution for the loss of his personal rights. See I.T. 2420, VII-2 Cum. Bull. 123 (1928), and Rev. Rul. 54-19, 1954-1 Cum. Bull. 179 (wrongful death award); Rev. Rul. 55-132, 1955-1 Cum. Bull. 213, and Rev. Rul. 56-462, 1956-2 Cum. Bull. 20 (awards to maltreated prisoners of war); Rev. Rul.



56-518, 1956-2 Cum. Bull. 25; Rev. Rul. 57-505, 1957-2 Cum. Bull. 50; Rev. Rul. 58-370, 1958-2 Cum. Bull. 14; and Rev. Rul. 58-500, 1958-2 Cum. Bull. 21 (payments by foreign countries to victims of persecution for loss of personal rights).

Damages for defamation of a man's personal reputation and character (*Hawkins v. Commissioner*, 6 B.T.A. 1023), breach of contract to marry (*McDonald v. Commissioner*, 9 B.T.A. 1340) and for a tortious injury to goodwill (*Farmers' & Merchants' Bank v. Commissioner*, 59 F.2d 913 (C.A. 6th)) have similarly been held not taxable on the ground that such payments recompense the taxpayer and make him whole for the damages suffered.

Since the consenting person admits, in effect, that no wrong will be done to him by the act permitted through surrender of his legal right, an entirely different tax result obtains where there is a voluntary waiver, for consideration, of a legal right in that there is no ensuing injury and tortious loss of a personal right. As stated in *Runyon v. United States*, (S.D. Fla.), decided June 24, 1959 (4 A.F.T.R. 2d 5354), affirmed, 281 F. 2d 590 (C.A. 5th) (on the ordinary income versus capital gain issue)—

The \* \* \* contention of the plaintiff, that the proceeds of this contract were actually the prepayment of compensatory damages, is without merit, for compensatory damages presuppose injury or wrong, *Sanders v. Rolink*, 67 N.Y.S. 2d 652, 188 Misc. 627, *Reid v. Terwilliger*, 116 N.Y. 530, 22 N.E. 1091. There has been no legal injury or wrong in this case \* \* \*.

The court below did not base its decision on this ground, however, (R. 18-19), but, assuming, *arguendo*, that the two situations are to be treated the same for tax purposes, held that the taxpayer at bar cannot prevail because there was no showing in fact that her privacy had been invaded (R. 18), and thus she had not established that she suffered any injury.

The record in this case, contrary to the assumption in taxpayer's brief (Br. 4), is simply devoid of any evidence indicating that there was an actual invasion of her privacy. The record only shows that the picture, "The Wings of Eagles", depicted events from the life of her father, but there is not a shred of evidence that taxpayer was portrayed in the film, or that there was even any reference to her in the picture. Hence, even if it is further assumed, *arguendo*, that taxpayer received the \$5,800 solely for the release of her right to privacy,<sup>5</sup> there is no basis in the record

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<sup>5</sup> In point of fact, taxpayer received the \$5,800 not only for waiving her right to privacy but also for agreeing to render services such as delivering photographs, letters family documents, and other family information to Loew's. (R. 16.) Taxpayer also agreed to use her best efforts to obtain approval and the necessary signatures for the bank's sale of "We Plaster the Japs" to Loew's. (Ex. 4-D.) Compensation for agreeing to render such services is, of course, taxable as ordinary income to taxpayer whether or not she actually was called upon to render those services. Since she failed to show the amount, if any, of the \$5,800 that was allocable to the release of her right to privacy, and the amounts that were allocable to compensation for her services and for consenting to the other provisions of the agreement, taxpayer did not carry her burden of proving the Commissioner's determination erroneous and in no event could she therefore prevail. *H. Liebes & Co. v. Commissioner*, 90 F.2d 932, 935 (C.A. 9th).



for concluding that her privacy was invaded, and thus, the \$5,800 cannot be considered as recompense which made her whole for an injury to her.<sup>6</sup>

Since the \$5,800 was not such compensation, that sum perforce was taxable gain to her under the rationale of *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 429. The same conclusion was reached in *Meyer v. United States*, 173 F. Supp. 920 (E.D. Tenn.). See also *Runyon v. United States*, 281 F. 2d 590 (CA 5th); *Miller v. Commissioner*, 35 T.C. 631, 641, appeal pending (C.A. 2d); and *Myers v. Commissioner*, 287 F. 2d 400 (C.A. 6th), certiorari denied, 368 U.S. 828.

Taxpayer argues (Br. 4-5) that public exhibition of her family life is *ipso facto* an invasion of her privacy; she ignores the lack of evidence bearing on an invasion of her privacy and the California cases holding that there is no right to privacy in another's life.

It should be noted that taxpayer in her argument does not rely on Section 104(a)(2) of the 1954 Internal Revenue Code, *supra*, although she does make reference to it in stating the question involved in this appeal. Section 104(a)(2) provides that gross income does not include "the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness." Section 104(a)(2) pat-

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<sup>6</sup> It is interesting to note that taxpayer's petition to the Tax Court (R. 3-5) failed to state a cause of action even under this view of the law for she alleged therein neither that her right to privacy had been invaded nor facts leading to that conclusion.



ently is not applicable because the taxpayer did not receive any damages on account of a personal injury. Not only was there no injury (as we have pointed out above) but taxpayer received the \$5,800 not on account of an injury but rather (in part) for the release of a right. In sum, we submit that the amount received by taxpayer for consenting to a potential invasion of her privacy was properly includible in her gross income and that the taxpayer has not carried her burden of affirmatively establishing that the decision below was clearly erroneous.

### CONCLUSION

For the reasons stated above, the decision of the Tax Court should be affirmed.

Respectfully submitted,

LOUIS F. OBERDORFER,  
*Assistant Attorney General.*

LEE A. JACKSON,  
DAVID ~~AO~~.WALTER,  
HAROLD M. SEIDEL,  
*Attorneys,*  
*Department of Justice,*  
*Washington, D. C.*

JANUARY, 1962.



No. 17358 ✓

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**United States  
Court of Appeals**  
for the Ninth Circuit

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MAURIE STARRELS and DORIS W. STARRELS,  
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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**Transcript of Record**

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Petition to Review a Decision of the Tax Court  
of the United States





No. 17358

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**United States  
Court of Appeals  
for the Ninth Circuit**

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MAURIE STARRELS and DORIS W. STARRELS,  
Petitioners,  
vs.  
COMMISSIONER OF INTERNAL REVENUE,  
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**Transcript of Record**

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Petition to Review a Decision of the Tax Court  
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## INDEX

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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## APPEARANCES

KENNY, MORRIS & IBANEZ,

ROBERT W. KENNY,

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Los Angeles 26, California,

For Petitioners.

LOUIS F. OBERDORFER,

Assistant Attorney General,

HART H. SPIEGEL,

Chief Counsel,  
Internal Revenue Service,  
Washington 25, D. C.,

For Respondent.





The Tax Court of the United States

Docket No. 77031

MAURIE STARRELS and DORIS W. STARRELS,  
Petitioners

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

PETITION

The above named petitioners hereby petition for a re-determination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (Ap: LA: AA-ESM (CRW) 90-D) dated July 14, 1958 (Associate Chief, Appellate Division, 1250 Subway Terminal Building, 417 South Hill Street, Los Angeles 13, California) and as the basis for their case, allege as follows:

1. That petitioners are husband and wife, residing at 6531 West Fifth Street, Los Angeles 48, California. The return for the period here involved was filed with the District Director of the Internal Revenue Service at Los Angeles, California.

2. The notice of deficiency (a copy of which is attached, marked "Exhibit A") was mailed to the petitioners on July 14, 1958.

3. The deficiency as determined by the Commissioner, is in income taxes for the calendar year 1956, in the amount of \$1,530.87. The entire amount is in controversy.

4. The determination of tax set forth in said Notice of Deficiency is based upon an error of law in

holding that the amount of \$5,800.00, received by petitioner Doris W. Starrels from Loew's, Inc. in compensation for the violation of her rights of privacy by the production of a motion picture of the life story of Commander Frank W. Wead, USN, her deceased father, under the provisions of a contract with Loew's, Inc. dated November 9, 1954, was taxable.

5. The facts upon which petitioners rely as the basis of this case are as follows:

(a) Petitioner Doris W. Starrels is the daughter of the late Commander Frank W. Wead, USN.

(b) On November 9, 1954 petitioner Doris W. Starrels, entered into a contract with Loew's, Inc. in which it was recited that Loew's desired and intended to produce a photoplay "based on, adapted from, or using as a springboard the life story" of Commander Wead. As a consideration for the payment of an agreed sum of money (the taxability of which constitutes the dispute in this proceeding) the petitioner Doris W. Starrels, agreed that Loew's, Inc. could depict said petitioner, her father and other members of her family in photoplays, using their likenesses in photographs and the actual names of petitioner and other members of their family; including actual incidents involving Commander Wead and his family. In said contract petitioner, Doris W. Starrels, agreed that at no time would she claim that such photoplay or any use made of the family names, likenesses, pictures and characterizations would constitute a violation of any of her rights including her right of privacy and she released Loew's, Inc. from any claims arising out of or in connection with any photoplays produced by it.



(c) No services were performed nor any tangible property was ever delivered by petitioner Doris W. Starrels to Loew's, Inc.

(d) In the year 1956 Loew's, Inc. produced and distributed throughout the United States a feature motion picture entitled "The Wings of Eagles," starring John Wayne, Dan Daily and Maureen O'Hara, and depicting the birth of naval aviation and events taken from the life of petitioner Doris W. Starrels' deceased father, Commander Wead, USN.

(e) During the taxable year 1956, Loew's, Inc. paid to petitioner Doris W. Starrels the sum of \$5,800.00, pursuant to the terms of said contract of November 9, 1954.

Wherefore, the petitioners pray that this Court may try the case and determine that there is no deficiency in income tax due from the petitioners for the calendar year 1956 and give such other and further relief as may be just and equitable in the premises.

/s /MAURIE STARRELS

/s/ DORIS W. STARRELS

Petitioners

6531 West Fifth Street

Los Angeles 48, California

KENNY, MORRIS & IBANEZ

By ROBERT W. KENNY

Attorneys for Petitioners

1557 Beverly Boulevard

Los Angeles 26, California

MAdison 9-1137

6      *Maurie Starrels and Doris W. Starrels vs.*

Duly Verified:

Form 1230 (App.)  
1250 Subway Terminal Building  
417 South Hill Street  
Los Angeles 13, California

Ap:LA:AA-ESM  
(CRW) 90-D

Mr. Maurie Starrels and  
Mrs. Doris W. Starrels  
Husband and Wife  
6531 West Fifth Street  
Los Angeles 48, California

Dear Mr. and Mrs. Starrels:

You are advised that the determination of your income tax liability for the taxable year (s) ended December 31, 1956, discloses a deficiency of \$1,530.87 as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address, Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays, and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it

to the Assistant Regional Commissioner, Appellate, Room 1250, 417 So. Hill St., Los Angeles 13, California. The signing and filing of this form will expedite the closing of your return(s) by permitting an early assessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earlier.

Very truly yours,

RUSSELL C. HARRINGTON

Commissioner,

By

Associate Chief, Appellate Division

Enclosures:

Statement

IRS Pub. 160

Agreement Form

6-24-1958

Ap:LA:AA—ESM

(CRW) 90-D

Statement

Mr. Maurie Starrels and

Mrs. Doris W. Starrels

Husband and Wife

6531 West Fifth Street

Los Angeles 48, California

Tax Liability for the Taxable Year Ended

December 31, 1956

Year

1956

Income Tax

Deficiency

\$1,530.87





(b) As a result of the addition to income, item (a), a medical expenses claimed in your return are adjusted as follows:

Adjusted gross income per return	\$14,214.49
Add: Income increased	5,800.00
Adjusted gross income as revised	<u>\$20,014.49</u>

	Per Return	As Adjusted
Medicine and drugs paid	<u>\$ 150.00</u>	<u>\$ 150.00</u>
Less: 1% of Adjusted Gross Income	142.14	200.14
Medicine and drugs reportable	<u>\$ 7.86</u>	<u>None</u>
Other medical expenses paid	4,388.04	\$ 4,388.04
Total medical expenses	<u>\$4,395.90</u>	<u>\$ 4,388.04</u>
Less: 3% of Adjusted Gross Income	426.42	600.43
Medical expenses allowable	<u>\$3,969.48</u>	<u>\$ 3,787.61</u>
Medical expenses disallowed		\$ 181.87

Computation of Tax  
Year 1956

Taxable net income	\$12,685.71
Total tax on \$12,685.71	\$ 2,925.71
Less: Dividends Received Credit	141.24
Correct income tax liability	<u>\$ 2,784.47</u>
Income tax liability shown on return, Account No. BC 11484, Los Angeles District	1,253.60
Deficiency of income tax	<u>\$ 1,530.87</u>

Received, Filed and Served Oct. 2, 1958.

[Title of Tax Court and Cause.]

ANSWER

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1, 2, and 3. Admits the allegations contained in paragraphs 1, 2, and 3 of the petition.

4. Denies the allegation of error contained in paragraph 4 of the petition.

5. (a) Admits the allegation contained in subparagraph (a) of paragraph 5 of the petition.

(b) Admits that on November 9, 1954, petitioner Doris W. Starrels entered into a contract with Loew's Inc. in which it was recited that Loew's desired and intended to produce a photoplay "based on, adapted from, or using as a springboard, the life story" of Commander Wead; and denies the remaining allegations contained in subparagraph (b) of paragraph 5 of the petition.

(c) Denies the allegations contained in subparagraph (c) of paragraph 5 of the petition.

(d) and (e) Admits the allegations contained in subparagraphs (d) and (e) of paragraph 5 of the petition.

6. Denies generally and specifically each and every allegation in the petition not hereinbefore specifically admitted, qualified or denied.



Wherefore, it is prayed that the deficiency determined by the respondent be in all respects approved.

/s/ ARCH M. CANTRALL,  
Chief Counsel,  
Internal Revenue Service.

Of Counsel:

Melvin L. Sears  
Regional Counsel

Richard W. Janes  
Cyrus A. Johnson  
Attorneys

Internal Revenue Service  
1135 Subway Terminal Bldg.  
417 So. Hill Street  
Los Angeles 13, California.

Received and Filed November 28, 1958.

Served December 1, 1958.

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[Title of Tax Court and Cause.]

### STIPULATION OF FACTS

It is hereby stipulated that for the purpose of this case, the following statements may be accepted as facts, and all exhibits referred to herein, and attached hereto, are incorporated in this stipulation and made a part thereof provided, however, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

12    *Maurie Starrels and Doris W. Starrels vs.*

1. The petitioners,<sup>1</sup> Maurie and Doris W. Starrels, are individuals, husband and wife, residing at 6531 West Fifth Street, Los Angeles 48, California. They use the cash method of accounting, and file their returns jointly on a calendar year basis. Their joint return for the calendar year 1956 was filed with the District Director of Internal Revenue at Los Angeles, California. Attached hereto as Exhibit 1-A is a true and correct copy of such return.

2. Petitioner and her sister, Lila Berman, are the daughters and only issue, of the late Commander Frank W. Wead, U.S.N.

3. Loew's, Inc. desired to produce a motion picture concerning naval aviation, and ultimately did produce and market such a picture.

4. Loew's, Inc. intended the photoplay to be "based on, adapted from, or using as a springboard the life story" of Commander Wead.

5. In furtherance of this purpose Loew's, Inc. purchased from the Beverly Hills National Bank and Trust Company, trustee under the will of Commander Wead,

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<sup>1</sup>Maurie Starrels is a party to this proceeding only by reason of filing a joint return for the year 1956. Doris W. Starrels was the actual recipient of the disputed gain, and for convenience and clarity will hereinafter be referred to as the petitioner.

the literary material "We Plaster the Japs" which was written by Commander Wead and published in the September, 1944 issue of American Magazine. Attached hereto as Exhibit 2-B is a true and correct copy of the purchase agreement.

6. Loew's, Inc. also entered into an agreement with the petitioner and her sister on November 9, 1954. The agreement is contained in two documents, styled an "option" and a "consent." Attached hereto as Exhibits 3-C and 4-D are true and correct copies of these documents.

7. In 1956, Loew's, Inc. produced and distributed throughout the United States a feature motion picture in which was depicted events taken from the life of Commander Wead.

8. Pursuant to the contract of November 9, 1954, Loew's, Inc. paid \$5,800.00 to the petitioner in 1956.

/s/ ROBERT W. KENNY,  
Counsel for Petitioner

/s/ HART H. SPIEGEL,  
Chief Counsel  
Internal Revenue Service  
Counsel for Respondent.

Filed June 13, 1960.

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[Title of Tax Court and Cause.]

Docket No. 77031. Filed January 26, 1961.

Held, payment made for a right of privacy release in connection with the production of a motion picture, in advance of any privacy invasion and in circumstances where no invasion of privacy was shown to have followed, constitutes taxable income.

Robert W. Kenny, Esq., for the petitioners.

Charles F. Quinlan, Esq., for the respondent.

#### OPINION

RAUM, Judge: The Commissioner determined a deficiency in petitioners' income tax for the year 1956 in the amount of \$1,530.87. The only question is whether an amount received in 1956 by petitioner Doris W. Starrels from Loew's, Inc. in exchange for a release of any claims she might have for invasion of her right of privacy constitutes taxable income. The facts have been stipulated.

Petitioners Maurie and Doris W. Starrels husband and wife, reside at 6531 West Fifth Street, Los Angeles 48, California. They filed their joint income tax return for the calendar year 1956 with the district director of internal revenue, Los Angeles, California.

Petitioner Doris W. Starrels, hereinafter referred to as Doris, and her sister, Lila Berman, are the daughters and only issue of the late Commander Frank W. Wead, U.S.N.

Loew's, Inc., hereinafter referred to as Loew's, desired to produce a motion picture concerning naval aviation and ultimately did produce and market such a picture. It intended the photoplay to be "based on, adapted from, or using as a springboard the life story" of Commander Wead.

In 1954 in furtherance of this purpose, Loew's purchased from the Beverly Hills National Bank and Trust Company, trustee under the will of Commander Wead, the literary material entitled "We Plaster the Japs" which was written by Commander Wead and published in the September 1944 issue of American Magazine.

Loew's also entered into an agreement with Doris and with Lila Berman on November 9, 1954. This agreement consisted of two documents: a letter from Loew's to Doris and Lila referred to as an option and a letter from the sisters to Loew's referred to as a release. Among other things, the terms of the agreement provide:

(a) Doris and Lila agreed to permit Loew's to produce, release, distribute, and exhibit a motion picture based on the life of their late father, Commander Wead.

(b) Doris and Lila agreed to permit Loew's to depict their deceased father, themselves, and other members of their family in the photoplay and in the advertising and publicity thereof and to use actual names or fictitious names for themselves and other members of their family.

(c) The sisters promised that at no time would they claim or assert that the photoplay or any matter there-

in contained or any use made by Loew's of the names, likenesses, pictures or characterizations of their father, themselves, or other members of their family under the agreement constituted a violation of any of their rights, including their rights of privacy.

(d) Doris and Lila agreed to deliver to Loew's such material in the way of photographs, letters, family documents, facts or other material or information and suggestions which were available and which could be helpful in the preparation of the motion picture.

(e) The sisters agreed that during the life of the agreement they would not authorize others to produce or exhibit any motion picture photoplay nor would they consent to the portrayal, depiction, or impersonation of their father or of themselves in any other motion picture.

(f) Loew's was further granted the right to advertise, promote, and exploit the photoplay by all means customarily used in the trade.

(g) Doris and Lila were to receive \$2,400 jointly upon the execution of the agreement and were to be paid further sums upon the happening of specified events and/or upon the satisfaction of certain conditions.

In 1956 Loew's produced and distributed through the United States a feature motion picture entitled "The Wings of Eagles" which depicted events taken from the life of Commander Wead.

Pursuant to the agreement of November 9, 1954, Loew's paid Doris the sum of \$5,800 in 1956. On her 1956 joint income tax return, Doris noted this receipt as follows: "\$5,800.00 received from Loew's, Inc.



M.G.M. Pictures as payment for invasion of personal family rights—not included as taxable income.” Respondent in his deficiency notice to petitioners determined that the entire amount of the receipt from Lowew’s should have been included in taxable income.

Petitioners’ sole contention is that a payment made for a consent to an invasion of privacy does not constitute taxable income. The contrary has been decided. *Damon Runyon, Jr. v. United States*, 281 F. 2d 590 (C. A. 5); *Ehrlich v. Higgins*, 52 F. Supp. 805 (S.D. N.Y.); *Meyer v. United States*, 173 F. Supp. 920 (E.D. Tenn.); *Helen D. Miller*, 35 T.C.—, decided this day. In each of these cases, the payments were held to result in the receipt of ordinary income. We believe the logic of these cases is controlling in the instant case, and thus we think the Commissioner correctly determined that the petitioners should have included the disputed \$5,800 in taxable income in 1956.

The factual situation in the present case bears a striking resemblance to the facts in the *Ehrlich*, *Meyer*, and *Miller* cases.<sup>1</sup> Here, as in those cases, a motion picture company made certain payments connected with the production of a partially biographical photoplay in exchange, at least in part, for a release of any right of privacy claims that the payees might assert based on the resulting motion picture. Here, as was also true in those cases, there is no evidence whatsoever that the resulting motion picture in fact injured or damaged the

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<sup>1</sup>Unlike *Runyon*, it has not been argued here that the payments involved the rights of the deceased father. Unlike *Miller*, it has not been argued here in petitioners’ behalf that a capital asset was sold nor in respondent’s behalf that personal services were compensated.

payee by an invasion of her right of privacy or in any other way.

Petitioners argue that if damages paid for a consummated invasion of the right of privacy would not be taxable, payments made pursuant to an agreement which included a consent to such an invasion should be equally exempt. Such an argument was specifically rejected in both *Ehrlich* and *Meyer*. In the instant case, Loew's was granted the right to invade Doris' right of privacy by agreement, but there is no evidence that the resulting motion picture released by Loew's in fact invaded her right of privacy in any manner. If the payments based on this agreement could be made tax exempt by merely referring to a right of privacy which was never invaded and possibly never intended to be invaded, the narrowly conceived statutory exclusion for damages on account of "personal injuries" (Section 104(a)(2), Internal Revenue Code of 1954)<sup>2</sup> would be expanded beyond its normal meaning. We think that Congress intended no such result.

Whether money paid to obtain a release for a right of privacy invasion in advance of such an invasion should be excluded from taxable income where there is proof that an invasion of privacy actually followed—is a question not raised by the facts in the present case. It may well be that the voluntary advance waiv-

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<sup>2</sup>The legal basis for petitioners' claim that the amount received was nontaxable is not clearly articulated in their brief. We think that the payment for surrender of the right of privacy consists of gross income under Section 61, and no statutory provision other than Section 104(a)(2) has been suggested as a basis for excluding the payment from gross income.

er of one's personal rights for compensation takes the case outside the purview of Section 104(a)(2). Thus, one may receive compensation for allowing medical experiments upon his body in circumstances that would constitute a tort if his prior consent had not been given. We have considerable doubt whether it was the purpose of Section 104(a)(2) to remove such compensation from the category of taxable income. However, that is a question that need not be reached on this record. Suffice it to say for purposes of deciding this case, we think no valid claim for exclusion may be made in this area without some showing of an injury which has been sustained. This the petitioners have wholly failed to do.

Decision will be entered for the respondent.

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Tax Court of the United States

Washington

Docket No. 77031

MAURIE STARRELS and DORIS W. STARRELS,  
Petitioners

v.

COMMISSIONER OF INTERNAL REVENUE

Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion, filed January 26, 1961, it is

Ordered and Decided: That there is a deficiency in income tax for the year 1956 in the amount of \$1,530.87.

/s/ ARNOLD RAUM

Judge.

Entered Jan. 27, 1961.

Served Jan. 30, 1961.



[Title of Tax Court and Cause.]

PETITION FOR REVIEW OF DECISION AND  
ORDER OF THE TAX COURT

To the Honorable Judges of the United States Court  
of Appeals for the Ninth Circuit:

Now come Maurie Starrels and Doris W. Starrels,  
Petitioners on Review herein, by their attorneys, Ken-  
ny, Morris & Ibanez, and respectfully show:

I.

Jurisdiction

The Petitioners on Review (hereinafter referred to as the taxpayers) are individuals whose address is 6531 West Fifth Street, Los Angeles, California. Their income tax return for the calendar year 1956 was filed with the District Director of Internal Revenue, Los Angeles, California, which is within the jurisdiction of the United States Court of Appeals for the Ninth Circuit, wherein this review is sought.

The Respondent on Review (hereinafter referred to as the Commissioner) is the duly appointed, qualified and acting Commissioner of Internal Revenue, appointed and holding his office by virtue of the laws of the United States.

The taxpayer seeks a review of the decision of the Tax Court of the United States pursuant to the provisions of Sections 7482 and 7483 of the Internal Revenue Code of 1954.

## II.

## Prior Proceedings

On July 14, 1958, the Commissioner issued and sent to the taxpayer, by registered mail, a notice of deficiency in which he determined that the taxpayer owed a deficiency in income tax for the calendar year of 1956 in the amount of \$1,530.87.

Thereafter, on October 2, 1958, the taxpayer filed an appeal from said determination with the Tax Court of the United States. The case was tried on a stipulation of facts before the Honorable Arnold Raum, Judge of the Tax Court of the United States, on June 13, 1960, in Los Angeles, California.

On January 27, 1961, the Tax Court entered its opinion written by Judge Raum. On January 27, 1961, the Tax Court entered its decision ordering and deciding that the taxpayer owed a deficiency in income tax for the calendar year 1956 in the amount of \$1,530.87 (35 T.C.—, No. 69).

## III.

## Nature of the Controversy

Petitioner Doris W. Starrels, hereinafter referred to as "Doris" and her sister, Lila Berman, were the daughters and only issue of the late Commander Frank W. Wead, USN. Loew's, Inc. desired to produce a motion picture concerning naval aviation and ultimately did produce and market such a picture "based on, adopted from or using as a springboard the life story" of Commander Wead. On November 9, 1954 Loew's entered into an agreement with Doris and her sister.

By this agreement Doris and her sister agreed to permit Loew's to depict their deceased father, themselves and other members of their family in the photoplay, and the sisters promised that they would not claim that such use by Loew's of the names, likenesses, pictures, or characterizations of their father or themselves, or other members of their family would constitute a violation of any of their rights, including their rights of privacy.

In 1956, Loew's produced and distributed throughout the United States a feature motion picture entitled, "The Wings of Eagles," which depicted events taken from the life of Commander Wead. Pursuant to this Loew's paid Doris the sum of \$5,800.00 in 1956.

The sole contention presented by petitioners is that this payment was made for a consent to an invasion of a personal right of privacy and as such does not constitute taxable income.

#### IV.

##### Assignment of Errors

The taxpayers aver that in the opinion and final decision rendered and entered by the Tax Court of the United States that court erred as follows:

1. In holding that the money received from Loew's was taxable income on the stated ground of absence of evidence that the motion picture, in fact, injured or damaged the payee by an invasion of her right of privacy or in any other way.

2. In failing to rule upon petitioners' contention that, unlike libel and slander, the gist of the action in privacy cases is not injury to the character or rep-



utation, and that an invasion of privacy occurs without regard to any effect which the publication may have on the standing of the individual in the community.

3. In that the decision was contrary to law.

Wherefore, taxpayers petition that the opinion and decision hereinabove referred to be reviewed by the United States Circuit Court of Appeals for the Ninth Circuit; that a transcript of the record be prepared in accordance with the law and with the Rules of said court and transmitted to the clerk of said court for filing; and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said court.

KENNY, MORRIS & IBANEZ

/s/ By ROBERT W. KENNY

Attorneys for Petitioners

on Review

Duly Verified.

Received and Filed Mar. 23, 1961.

[Endorsed]: No. 17358. United States Court of Appeals for the Ninth Circuit. Maurie Starrels and Doris W. Starrels, Petitioners, vs. Commissioner of Internal Revenue, Respondent. Transcript of Record. Petition to Review a Decision of the Tax Court of the United States.

Filed: April 24, 1961.

Docketed: May 9, 1961.

/s/ FRANK H. SCHMID,

Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals  
For the Ninth Circuit

No. 17358

MAURIE STARRELS and DORIS W. STARRELS  
Petitioners in Review

vs.

COMMISSIONER OF INTERNAL REVENUE  
Respondent on Review

PETITIONERS' STATEMENT OF POINTS

Comes now the petitioners on review in the above entitled cause by and through their attorneys, hereby state that they intend to rely upon the following points in this proceeding:

1. The Tax Court of the United States erred in holding that the money received from Loew's was taxable income because of the absence of evidence that the motion picture, in fact, injured or damaged the payee by an invasion of her right of privacy or in any other way.

2. In failing to rule upon petitioners' contention that, unlike libel and slander, the gist of the action in privacy cases is not injury to the character or reputation, and that an invasion of privacy occurs without regard to any effect which the publication may have on the standing of the individual in the community.

3. In that the decision was contrary to law.

KENNY, MORRIS & IBANEZ

By ROBERT W. KENNY

Attorneys for Petitioners on Review

[Endorsed]: Filed June 28, 1961. Frank H. Schmid,  
Clerk.

[Title of Court of Appeals and Cause.]

STIPULATION RE ORIGINAL EXHIBITS

Subject to the approval of the Court it is hereby stipulated and agreed by and between the parties in the above-entitled cause, through their counsel of record, that Exhibits 1-A through 4-D attached to the Stipulation of Facts be not included in the printed record, and that they may be referred to by the parties in all briefs (or quoted or otherwise reproduced in whole or in part therein) and at the oral argument, and that they may be considered and relied upon by the Court in their original form as if contained in the printed record.

KENNY, MORRIS & IBANEZ

By ROBERT W. KENNY

Attorneys for Petitioners

/s/ LOUIS F. OBERDORFER

Assistant Attorney General

Attorney for Respondent

July 31, 1961.

So Ordered:

/s/ RICHARD H. CHAMBERS,

Chief Judge, U. S. Court of Appeals for  
the Ninth Circuit.

[Endorsed]: Filed Aug. 7, 1961. Frank H. Schmid,  
Clerk.





No. 17361✓

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**United States**  
**COURT OF APPEALS**  
**for the Ninth Circuit**

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STANDARD LUMBER CO., formerly  
Pilot Rock Lumber Co.,

*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

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**PETITIONER'S BRIEF**

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*Appeal from the Tax Court of the United States.*

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FILED

SEP 2 1917

MAUTZ, SOUTHER, SPAULDING, KINSEY & WILLIAMSON, SCHMID, CLERK  
WILLIAM H. KINSEY,  
Tenth Floor, Board of Trade Building,  
Portland 4, Oregon,  
*Attorneys for Petitioner.*

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No. 17361

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**United States**  
**COURT OF APPEALS**  
**for the Ninth Circuit**

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STANDARD LUMBER CO., formerly  
Pilot Rock Lumber Co.,

*Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

---

**PETITIONER'S BRIEF**

---

*Appeal from the Tax Court of the United States.*

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**STATEMENT OF PLEADINGS AND  
BASIS OF JURISDICTION**

This is an appeal from the decision of the Tax Court of the United States which affirmed the determination of the Commissioner of Internal Revenue that corporation income tax deficiencies existed as to the petitioner for the taxable years 1954 and 1955. Appellate jurisdiction and venue are granted this Court by 26 U.S.C.A. §§ 7482(a) and 7482(b)1. The Tax Court had jurisdiction by virtue of 26 U.S.C.A. § 7442.



## STATEMENT OF THE CASE

Petitioner, Standard Lumber Co., formerly Pilot Rock Lumber Co., is a dissolved and liquidated corporation which prior to its dissolution was incorporated under the laws of the state of Oregon, having its principal office at Pilot Rock, Oregon.

The controversy involves the proper determination of petitioner's liability for Federal Income Taxes for the taxable years 1954 and 1955. This in turn depends upon whether or not the petitioner and Oregon Fibre Products, Inc., an Oregon corporation (hereinafter referred to as "Oregon Fibre") were entitled to file a consolidated income tax return for the calendar year 1954 under the provisions of Section 1504(a)(2) of the Internal Revenue Code of 1954, and more specifically, whether or not petitioner at all times during the calendar year 1954 owned stock of Oregon Fibre possessing at least 80% of the voting powers.

At all times during the calendar year 1954 there were issued and outstanding no more than 120,000 shares of the common stock of Oregon Fibre. Petitioner owned 74,000 of such shares and 30,000 of such shares were held by voting trustees under a 20 year voting trust agreement dated November 3, 1952. In 1953 the Oregon Legislature passed a law, to be effective December 31, 1953, that a voting trust agreement could be created for a period not to exceed ten years (ORS 57.175). On January 1, 1955, by mutual agreement, the voting trust agreement dated November 3, 1952, was terminated.

Petitioner took the position that the 30,000 shares subject to the voting trust were divested of voting power by the passage of ORS 57.175 since a "pall of invalidity" was thereby placed over said trust and that neither the trustees nor equitable owners thereof had the right to vote said shares pending a judicial determination of the effect of ORS 57.175 on the validity of said voting trust. Therefore, petitioner, relying on its ownership of 74,000 of the remaining 90,000 shares of Oregon Fibre or 82% thereof, filed a consolidated return with Oregon Fibre for the calendar year 1954.

The Commissioner of Internal Revenue took the position that the 30,000 shares subject to said voting trust were shares with voting power and that, therefore, peittioner did not own at least 80% of the voting power of the Oregon Fibre stock and was thus not entitled to file a consolidated return with Oregon Fibre for the calendar year 1954. Because of this determination, the Commissioner recomputed petitioner's tax liability for the calendar years 1954 and 1955 and determined income tax deficiencies against petitioner as follows:

1954	-----	\$255,939.96
1955	-----	180,397.47

The opinion of the Tax Court of the United States affirmed the findings of the Commissioner of Internal Revenue that petitioner was not entitled to file a consolidated return for the calendar year 1954, and held that ORS 57.175 worked no suspension of the voting rights of the stock held in trust and that petitioner did not own stock of Oregon Fibre possessing at least 80% of the voting power in 1954 so as to entitle petitioner

and Oregon Fibre to file a consolidated return for that year. Thereafter, the Tax Court entered its decision under Rule 50 determining deficiencies in income tax due from the petitioner for the taxable years 1954 and 1955 in the amounts of \$208,092.16 and \$180,397.47, respectively.

### **SPECIFICATIONS OF ERRORS**

Petitioner contends that the Tax Court of the United States erred in the following particulars:

1. In finding and concluding that petitioner was not entitled to file a consolidated return with Oregon Fibre Products, Inc., an Oregon corporation, for the calendar year 1954, and therefore, in holding that there were deficiencies due from petitioner for the taxable years 1954 and 1955. This ultimate finding and conclusion of the Tax Court is based upon the subsidiary erroneous findings and conclusions specified in paragraphs 2 and 3 below.

2. In finding and concluding that the passage of § 57.175 of the Oregon Revised Statutes which became effective on December 31, 1953, did not result in a suspension of the voting power of 30,000 shares of Oregon Fibre Products, Inc. common stock held under a certain voting trust agreement created November 3, 1952, and terminated by mutual agreement on January 1, 1955.

3. In finding and concluding that § 57.175 of the Oregon Revised Statutes limiting the duration of voting trusts to ten years does not apply to pre-existing voting trusts so as to render them invalid if created for a period in excess of the statutory limit.



## SUMMARY OF ARGUMENT

Unlike the consolidated return arguments considered in prior reported cases, § 1504(a) of Internal Revenue Code of 1954 here involved, requires only that petitioner owned during 1954 Oregon Fibre Products, Inc. stock possessing 80% of the voting power,—not 80% of the voting stock. Where voting rights are suspended on voting stock, it is possible to own stock possessing 80% of the voting power without owning 80% of the voting stock. The voting rights on the 30,000 shares of Oregon Fibre Products, Inc., held under the Nov. 3, 1952 voting trust agreement were suspended during 1954, which suspension resulted in the fact that the 74,000 shares owned by petitioner possessed 80% of the voting power which could be marshalled at any stockholders' meeting held during 1954, the year in question. Such suspension of voting rights of the 30,000 shares was caused by the impact of the Oregon Business Corporation Act effective December 31, 1953 upon the voting trust. This Act limited voting trusts to a duration not in excess of ten years, while the November 3, 1952 voting trust had a duration of 20 years and was thus rendered invalid by the passage of this Act.

## ARGUMENT

The opinion of the Tax Court recognizes the fact that the subject twenty year voting trust agreement covering 30,000 shares of common stock of Oregon Fibre Products, Inc. was invalidated by Oregon Revised Stat-

utes § 57.175 authorizing voting trust agreements for periods not to exceed ten years, *if* Oregon Revised Statutes § 57.175 applies to voting trust agreements already in existence on December 31, 1953 when the section became effective as part of the new Oregon Corporation Law. However, the Tax Court finds that Oregon Revised Statutes § 57.175 does not apply to pre-existing voting trust agreements. The Court relies on Oregon Revised Statutes § 57.799 in support of its decision of inapplicability.

Oregon Revised Statutes, § 57.799 reads as follows:

“EFFECT OF REPEAL OF PRIOR ACTS. The repeal of a prior Act by chapter 549, Oregon Laws 1953, shall not affect any right accrued or established, or any liability or penalty incurred, under the provisions of such Act, prior to the repeal thereof. . .”

Oregon Revised Statutes § 57.799 quoted above applies only to a right accrued or established under laws repealed by the new Oregon Corporation Law. The old Oregon Corporation Law contained no provisions whatsoever relating to voting trusts, either condemning or condoning same. No prior statutory provision repealed by the new corporation law established any rights relating to voting trust agreements. Consequently, Oregon Revised Statutes § 57.799 is completely inapplicable.

Oregon Revised Statutes § 57.796(1) reads as follows:

“57.796. APPLICATION TO CORPORATIONS EXISTING ON DECEMBER 31, 1953. (1) The provisions of the Oregon Business Corporation Act shall apply to the fullest extent permitted by the laws and Constitution of the United States and of the State of Oregon,

to all existing corporations organized under any general Act of this state.”

Pilot Rock Lumber Co. was an existing corporation organized under a general act of the statute. Oregon Revised Statutes § 57.175 is a part of the *Oregon Business Corporation Act*. Consequently, Oregon Revised Statutes § 57.175 applies to the fullest extent permitted by the laws and Constitutions of the United States and of the State of Oregon. The nebulous status of voting trusts under Oregon law prior to Section 57.175 does not involve any constitutional issue, either state or federal. This leaves only Oregon law as a source for any provision which might preclude the applicability of Oregon Revised Statutes § 57.175 to a pre-existing voting trust agreement. As before mentioned, Oregon Revised Statutes Section 57.799 is inapplicable. No other statutory provision applies, and nothing in Oregon Revised Statutes § 57.175 itself makes any distinction between existing and future voting trust agreements. In contrast, some provisions of the new Oregon Business Corporation Law expressly provide that they shall not be applicable to existing agreements or documents. For example, Oregon Revised Statutes § 57.141 reads as follows:

“57.141. BYLAWS. The initial bylaws of a corporation shall be adopted by its board of directors. The power to alter, amend or repeal the bylaws or adopt new bylaws shall be vested in the board of directors unless reserved to the shareholders by the articles of incorporation or bylaws existing on December 31, 1953. . .”



Any applicability of *Western Pac. R. Corp. v. Baldwin*, cited by the Tax Court should be modified by the following quotation from the opinion (89 F.2d at 273):

"The Reconstruction Finance Corporation contends that, since Denver & Rio Grande is a Delaware corporation, and since the Delaware Corporation Law was amended in 1925—approximately one year after the voting trust agreement here involved was executed—so as to limit the maximum term of any voting trust agreement to ten years (34 Delaware Laws 1925, c. 112, § 6, p. 277), it must be held that no lawful extension of the voting trust agreement could be made. It is doubtful whether this issue of law was properly raised in the court below. The statute of Delaware is not mentioned in the pleadings, but the question is argued in the briefs and was called to the attention of the trial court. There is nothing in the amendatory act which specifically makes it applicable to voting trust agreements executed prior to its adoption. . . ."

A similar statement is contained in *Wolf v. Roosevelt*, the other case cited in the Tax Court opinion. The pertinent quotation from *Wolf v. Roosevelt* reads as follows (49 N.E.2d at 503):

". . . a statute restricting the power of individuals to create or define their rights and obligations should not be construed in manner which would affect existing agreements unless the Legislature so provided in express terms or by plain implication. The Legislature has not so provided in section 130-c of the Real Property Law. It seems plain that the condition, imposed by the Legislature to voting trust agreements,—that they shall not be valid unless 'approved by the court,' could not be applied to contracts made at a time when no such approval was required by law unless it was the intent of the Legislature to terminate all existing voting trust agreements. . . ."

Both of the above cases cited by the Tax Court hold that a statutory provision relating to voting trusts will be given retroactive application where such is provided by the express terms or by the plain implication of the statute. It is respectfully submitted that the implication of Oregon Revised Statutes § 57.175 itself favors retroactive application, and any doubt in this regard is eliminated by the express provision of Oregon Revised Statutes § 57.796 discussed above.

While the foregoing supports petitioner's position that Oregon Revised Statutes § 57.175 definitely invalidated the voting trust agreement, petitioner's position is not solely dependent thereon. It is sufficient if Oregon Revised Statutes § 57.175 cast a pall of invalidity upon the voting trust which pall could only be eliminated through judicial clarification or through mutual agreement of all the parties concerned, neither of which occurred during 1954, the only year in question. Such pall of invalidity is just as effective as positive invalidity under the practical approach hereinafter suggested by petitioner as the appropriate test to be applied in determining whether petitioner's own stock possessing 80% of the voting power.

Petitioner owned 74,000 out of 120,000 shares of outstanding common stock of Oregon Fibre Products, Inc. This is less than 80% of the outstanding shares. There is no issue concerning the preferred stock, it being stipulated that such stock does not possess voting rights and is limited and preferred as to dividends which, under the terms of § 1504, excludes it from the definition of "stock."



To qualify under the consolidated return requirements, it is necessary that there not be counted the 30,000 shares of stock held by the voting trustees under the voting trust agreement dated November 3, 1952. Petitioner's argument for not counting such 30,000 shares is based upon the difference between the phraseology of the applicable code provision here involved, and the phraseology of the corresponding code provision involved in all of the prior recorded cases having any pertinency to the issue. § 1504(a)(2), the pertinent provision of the Internal Revenue Code of 1954, here applicable, reads as follows:

“(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.”

The corresponding code provision involved in the prior cases reads as follows:

“The common parent corporation owns directly at least ——— percentum of each class of stock of at least one of the other includible corporations.”

Under the last-quoted provision, it would be necessary for petitioner to argue that the suspension of voting rights resulting under the voting trust converted the 30,000 shares into nonvoting stock so as to fall within the exclusion from the term “stock” of nonvoting stock which is limited and preferred as to dividends. Petitioner makes no such argument. It recognizes that the 30,000 shares were outstanding and that they do not fall within the beforementioned exclusion.



It does not necessarily follow that the 30,000 shares must be counted for consolidated return purposes just because the shares are outstanding and do not fall within the exclusion. The above-quoted phraseology of applicable § 1504(a)(2) requires only that the parent own *stock possessing at least 80% of the voting power*, which is substantially different from the requirement under a prior provision that the parent own at least the specified percent of each class of stock. It is possible to own stock possessing 80% of the voting power without owning 80% of the voting stock. This is clear from the differences in phraseology between § 1504(a)(2), and forms the very basis of petitioner's argument. To repeat,—it is possible to own stock possessing at least 80% of the voting power without owning 80% of the voting stock.

A case having a fact situation closest to that here involved is *Kansas O. & G. Ry. Co. v. Helvering*, 124 F.2d 460. A concise review and analysis of this case is contained in the following quotation from the opinion of this Court in *Pioneer Parachute Co.*, 6 T.C. 1246 at 1251-1252:

“We have not been furnished by either the petitioner or the respondent with any direct authorities on the solution of the question with which we are confronted, and it is not our intention to indulge in any prolonged discussion of the authorities cited. However, the powers of the class B preferred stockholders in this case do bear considerable analogy to those of the holders of the voting trust certificates involved in the case of *Kansas O. & G. Ry. Co. v. Helvering*, 124 Fed. (2d) 460. In that case, pending a reorganization, the stockholders and bondholders

of the petitioner railway delivered their stocks and bonds to a voting trustee to enable the trustee to act in the contemplated reorganization. After the voting trust was terminated notice was sent to all of the stockholders to reclaim their stock, but a substantial percentage neglected to do so. However, a consolidated return was filed by the affiliated group of corporations, including the reorganized railway, and the Commissioner questioned the right to a consolidated return because, if the voting shares of stock held by the trustee but unclaimed by the owners were counted, the parent company would not own the necessary percentage of the voting stock to permit a consolidated return. The court held that the outstanding unclaimed stock should be so counted and denied the privilege of filing a consolidated return. In so holding the court said:

“ ‘Nor is it of any consequence that the trust receipt holders cannot vote the stock to which they are entitled until stock certificates therefor have been issued to them. The stock is voting none the less. *It is the voting privilege with which a particular stock issued is endowed and not whether it is voted which determines its voting character within the intent of the Revenue Act of 1932 and 1934.*’ (Italics supplied)

“In that case the stockholder was required only to present his receipt and demand delivery of the voting stock from the voting trustee in order to acquire that stock. In the case at bar the holders of class B stock at any time had only to present their class B stock to the secretary of the company and demand their common voting stock in order to acquire the same.”

In *Kansas O. & G. Ry. Co. v. Helvering*, the taxpayer contended that suspension of voting rights by virtue of the unclaimed certificates in the terminated voting trust converted such unclaimed stock into nonvoting



stock qualifying under the statutory exclusion from the term "stock." This contention was necessary because the law then required ownership of a specified percentage of the stock,—not stock possessing a specified percentage of the voting power. What if the consolidated return requirements in *Kansas O. & G. Ry. Co. v. Helvering* was the same as in the present § 1504(a)(2)? Would not the parent have owned stock possessing the requisite percentage of the voting power? A negative answer might be based upon the fact that in *Kansas O. & G. Ry. Co. v. Helvering* the stockholder of the unclaimed certificate was required only to present his receipt and demand delivery of the voting stock from the voting trustee in which case the parent would not own stock possessing the requisite percentage of the voting power.

In the instant situation, the voting trust agreement dated November 3, 1952 containing the 30,000 shares was not terminated during 1954, and the voting trust certificate holders could not have received their voting shares from the trust by merely requesting same. Until the certificates were released from the voting trust and issued in the names of the certificate holders, the shares could not be voted by the certificate holders. Neither could the shares be voted by the voting trustees. A definite pall of invalidity was cast upon the voting trust by the Oregon Business Corporation Act adopted during the 1953 session of the Oregon legislature which became effective December 31, 1953. Section 32 of this Act (now Oregon Revised Statutes § 57.175) provides that a voting trust can be created for a period not to exceed ten



years. The voting trust agreement dated November 3, 1952 had a duration of 20 years. Such duration violated the ten year maximum specified in the before-mentioned statutory provision. Pending judicial clarification of the impact of this statutory provision upon a pre-existing voting trust, the voting trustees could not validly exercise their voting rights under the voting trust. Neither could the voting trust certificate holders exercise same until the stock was issued in their names. In the absence of a judicial determination, the matter could be resolved solely through a *mutual* termination of the voting trust agreement. No judicial determination was obtained or made during 1954, and the voting trust agreement was not terminated until January 1, 1955. Qualification to file consolidated returns after January 1, 1955 is no longer at issue.

From the December 31, 1953 effective date of the Oregon Business Corporation Act to the termination of the voting trust on January 1, 1955, the voting rights on the 30,000 shares in the voting trust were suspended by the impact of the ten year maximum voting trust duration specified in the new corporation law upon the pre-existing voting trust having a remaining duration substantially in excess of ten years. The 30,000 shares were voting stock, but the voting rights were definitely suspended during the full calendar year 1954.

With the voting rights suspended on the 30,000 shares, the 74,000 shares owned by petitioner possessed 80% of the voting power. Ownership of stock possessing 80% of the voting power is all that is required by

§ 1504(a)(2). It is not necessary that petitioner own 80% of the voting stock.

Petitioners submit that the practical approach should be adopted in determining whether there is stock ownership possessing 80% of the voting power. The practical approach can be applied through an assumed holding of a stockholders' meeting at any given moment during the subject year. At any such stockholders' meeting, how would the voting power of the stock owned by the parent compare with the total voting power which could be marshalled at any such meeting? All during 1954, petitioner owned 74,000 shares of the voting common stock. What voting power could have been marshalled against petitioner at any stockholders' meeting held at any time during 1954? Not, certainly, the 30,000 shares held by the voting trustees under a 20 year voting trust which applicable Oregon law authorizes for a period not in excess of 10 years. This leaves only the 16,000 shares owned by other individuals. Therefore, petitioner during 1954 owned stock possessing more than 80% of any voting power which could be marshalled at a stockholders' meeting held during 1954.

Petitioner's argument can be illustrated by analysis of the opinion in *Doernbecher Mfg. Co. v. Commissioner* (C.C.A. 9th, 1935), 80 F.2d 573, which affirmed a decision of this Court. In this case, the petitioner was the subsidiary corporation contending for consolidated return qualification. The petitioner was a party to a contract under which it was purchasing certain shares of its own stock. If these shares were not counted, there would have been the requisite stock ownership by the



parent. The pertinent portion of the Court's opinion reads as follows (80 F.2d at 574-575):

" . . . The petitioner relies upon a provision of its contracts to purchase the 9,152½ shares of stock, which is as follows: 'It is hereby expressly agreed that until the first party shall have foreclosed on said stock, as herein provided for, that said first party shall have no right to vote or draw dividends on said stock, or any part thereof, either in person or by proxy, it being expressly understood and agreed that the purchase price when paid is in full payment for said stock as of the date hereof.' Consequently, it is argued that this stock having been deprived of its voting and dividend privileges is expressly excluded from the stock to be considered in arriving at the 95 per cent. required by section 141 (d) of the Revenue Act of 1928 (26 U.S.C.A. Sec. 141 note) by that portion of the section which we quote: 'As used in this subsection the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.' Rev. Act 1928, Sec. 141(d)(2), 26 U.S.C.A. Sec. 141 note."

\* \* \* \* \*

" . . . The provision of the agreement for the sale of the stock above referred to with reference to the right of the seller to vote or draw dividends before foreclosure, whatever its effect, did not change the classification of the stock to 'non voting stock which is limited and preferred as to dividends.' Section 141 (d)(2), Rev. Act 1928, 26 U.S.C.A. Sec. 141 note, supra. It was still voting stock even if the right of the seller to vote it was temporarily suspended."

Petitioner in the instant proceedings agrees that the suspension of the voting rights on the 30,000 shares in the voting trust did not change the classification of the shares of nonvoting stock. The 30,000 shares were voting stock even though the voting rights thereon were



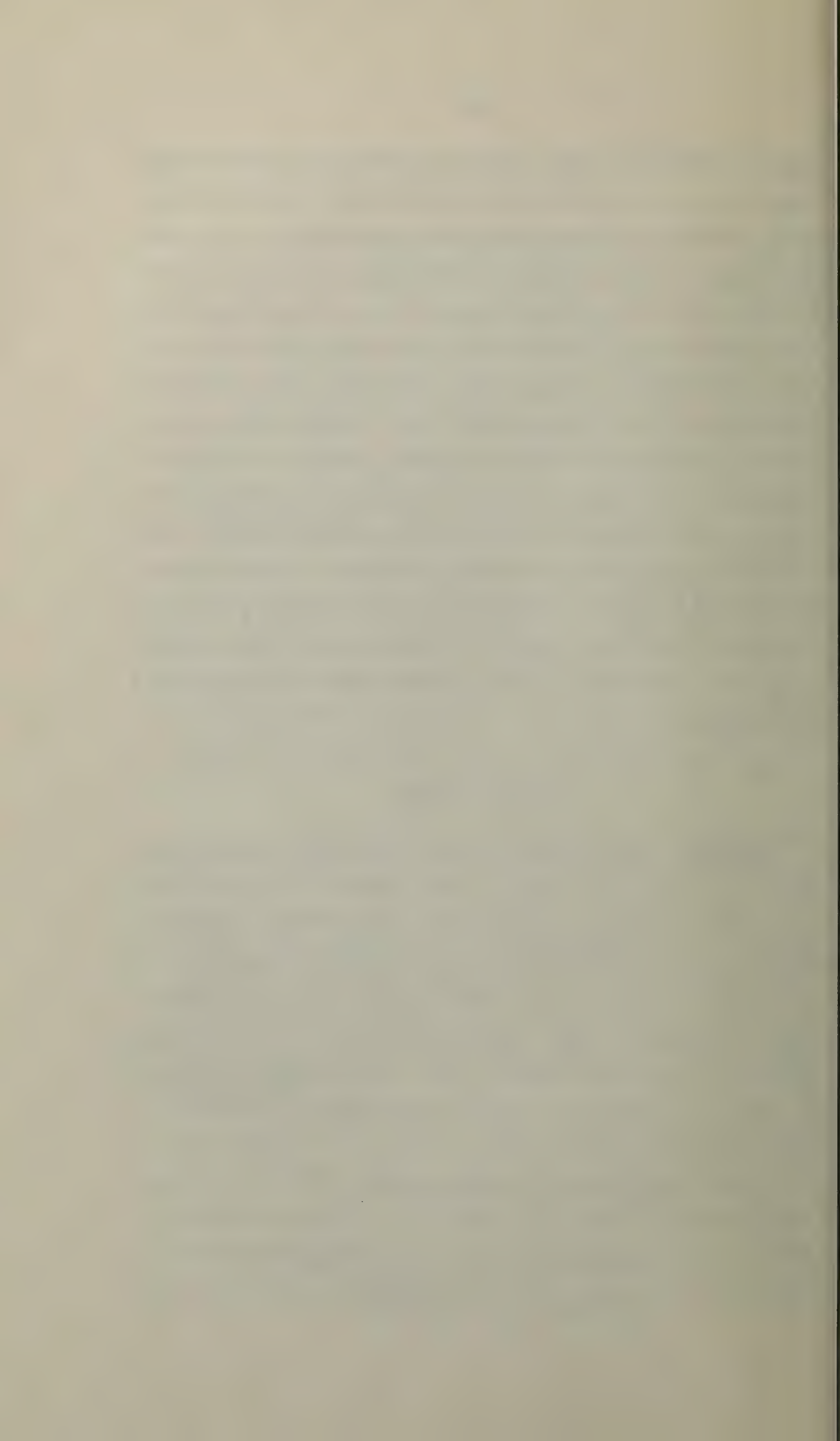
suspended during 1954. While such suspension of voting rights does not convert the 30,000 shares into nonvoting stock, such suspension does have a definite bearing upon the voting power possessed by the remaining shares. Any consideration of this point was not pertinent in *Doernbecher Mfg. Co.* because the qualification provision was different,—requiring ownership of the requisite percentage of the voting stock, not merely ownership of stock possessing the requisite voting power. A temporary suspension of voting power necessarily increases the voting power possessed by the remaining shares. The 30,000 shares did not possess effective voting power during 1954, so the 74,000 shares owned by petitioner possessed more than 80% of the voting power which could be marshalled at any stockholders' meeting held during 1954.

### CONCLUSION

Petitioner respectfully urges that the ultimate conclusion of the Tax Court is erroneous. Further, the subsidiary findings of the Tax Court are erroneous and do not support its ultimate finding. Petitioner, at all times during the year 1954 owned stock of Oregon Fibre Products, Inc., possessing 80% of the voting power of said corporation, and was, therefore, entitled to file a consolidated return with said corporation.

Respectfully submitted,

MAUTZ, SOUTHER, SPAULDING, KINSEY  
& WILLIAMSON,  
By WILLIAM H. KINSEY.



**In the United States Court of Appeals  
for the Ninth Circuit**

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**STANDARD LUMBER Co., formerly  
PILOT ROCK LUMBER Co., PETITIONER**

*v.*

**COMMISSIONER OF INTERNAL REVENUE, RESPONDENT**

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**On Petition for Review of the Decision of the  
Tax Court of the United States**

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**BRIEF FOR THE RESPONDENT**

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**In the United States Court of Appeals  
for the Ninth Circuit**

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No. 17361

STANDARD LUMBER Co., formerly  
PILOT ROCK LUMBER Co., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

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**On Petition for Review of the Decision of the  
Tax Court of the United States**

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**BRIEF FOR THE RESPONDENT**

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**OPINION BELOW**

The opinion of the Tax Court (R. 9-21) is reported at 35 T.C. 192.

**JURISDICTION**

This petition for review (R. 23-26) involves federal income taxes for the taxable year 1954. On September 11, 1958, the Commissioner of Internal Revenue mailed to the taxpayer notice of a deficiency for the year 1954 in the total amount of \$255,939.96.

(R. 10, 32.) Within ninety days thereafter the taxpayer filed a petition with the Tax Court for a redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954.<sup>1</sup> The decision of the Tax Court was entered December 27, 1960. (R. 22.) The case is brought to this Court by a petition for review filed March 23, 1960. (R. 23-26.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

### QUESTION PRESENTED

During 1954 the taxpayer owned approximately 62 per cent of the outstanding common stock of a second corporation, trustees under a voting trust agreement owned approximately 25 per cent, and all others owned approximately 13 per cent. The voting trust agreement was for a twenty-year period and was valid when executed in 1952. A subsequent state statute, effective December 31, 1953, provided that a voting trust can be created for a period not to exceed ten years.

The question is whether during 1954 the taxpayer owned directly stock possessing at least 80 per cent of the voting power of all classes of stock of the second corporation so as to entitle it to file a consoli-

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<sup>1</sup> The administrative records of the Internal Revenue Service indicate that taxpayer's petition was received by the Tax Court on December 12, 1958, but was postmarked December 8, 1958, and therefore should be deemed filed within ninety days after September 11, 1958, under Section 7502 of the Internal Revenue Code of 1954.

dated return with that company under Section 1504 (a) (2) of the Internal Revenue Code of 1954.

### STATUTES INVOLVED

The pertinent portions of the statutes involved are set forth in the Appendix, *infra*.

### STATEMENT

The facts, as found by the Tax Court (R. 10-21) and developed by stipulation (R. 27-33), may be summarized as follows:

The taxpayer, Standard Lumber Company, is a dissolved and liquidated corporation which was organized under the laws of the State of Oregon and had its principal office at Pilot Rock, Oregon. Liquidation of the taxpayer was completed on June 30, 1956. Oregon Fibre Products, Inc., hereinafter referred to as Products, also was incorporated under the laws of the State of Oregon and had its principal office at Pilot Rock. The taxpayer and Products maintained their books and reported income on an accrual method of accounting by calendar years, and timely filed a consolidated income tax return for 1954. (R. 11.)

During 1954 Products had two classes of authorized stock, common and preferred. The preferred stock did not possess voting rights and was limited and preferred as to dividends. During 1954 the taxpayer held approximately 62 per cent of Products' outstanding common stock, trustees under a voting



trust agreement held approximately 25 per cent, and all others held approximately 13 per cent.<sup>2</sup> (R. 11.)

The voting trust agreement under which the trusts outstanding during 1954 *held approximately 25 per cent of stock of P* was created on November 3, 1952, and was terminated by consent of all parties thereto by an agreement dated January 1, 1955. The voting trust agreement empowered the trustees to vote all the share of Products held under the agreement. It further provided that the trust agreement should continue for 20 years from its date. (R. 11.)<sup>3</sup>

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<sup>2</sup> At all times during 1954 there were issued and outstanding no more than 120,000 shares of the common stock of Products. Throughout 1954 taxpayer owned 74,000 of those shares and 30,000 shares were held in the names of the voting trustees. All other individuals held 14,900 shares on January 1, 1954, and 16,000 shares on December 31, 1954. (R. 28-29.) The common stock held by the voting trustees in 1954 was for the benefit of and for shares as follows (R. 29):

Pilot Rock Lumber Co.	
(taxpayer's former corporate name)	2,000
Harvey Gunderson	6,000
Carver Investment Company	22,000
	<hr/>
	30,000

<sup>3</sup> The voting trust agreement provided (R. 46) that it might be terminated at any time by the execution and acknowledgment by all the trustees of a "deed of termination" and that prior to termination the trustees might "in their discretion by written statement release a portion of the common stock" held under the agreement. The agreement further provided (R. 46):

Within sixty days after the termination of this agreement the Trustees shall deliver to the registered holders of all voting trust certificates, certificates for the num-

Section 57.175 of the Oregon Revised Statutes, a part of the Oregon Business Corporation Act which was passed during the 1953 session of the Oregon legislature and became effective December 31, 1953, provides that a voting trust can be created for a period not to exceed 10 years. (R. 11-12.)

The Commissioner determined deficiencies in taxpayer's income tax for 1954 on the ground that it was not entitled to file a consolidated return with Products for 1954. (R. 16.) In deficiency proceedings the Tax Court held that the voting trust in issue was valid under Oregon law when executed, that Section 57.175 of the Oregon Business Corporation Act was not intended to operate retrospectively and did not invalidate the pre-existing trust or suspend the voting rights of the shares of Products held in trust, and, therefore, that during 1954 taxpayer did not own stock in Products possessing 80 per cent of the voting power so as to <sup>initial it to</sup> file a consolidated return with Products under the criteria of Section 1504(a)(2) of the Internal Revenue Code of 1954. (R. 17-19.) Accordingly, the Tax Court sustained the Commissioner's determination of deficiencies in the amount of \$208,092.16 for 1954.<sup>4</sup>

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ber of shares of common stock represented by the voting trust certificates, upon surrender thereof, properly endorsed.

<sup>4</sup> The Tax Court also held that interest in the amount of \$92,015 on debentures issued by Products and held by taxpayer was not properly includible in taxpayer's income for 1954 since certain contingencies qualified the taxpayer's right to receipt of the interest. (R. 19-22.) The Commis-



## SUMMARY OF ARGUMENT

Under Sections 1501 and 1504 of the Internal Revenue Code of 1954 consolidated income tax returns may be filed only by certain chains of corporations in which the common parent "owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 per cent of each class of the nonvoting stock" of an includible corporation. The Tax Court correctly held that taxpayer failed to meet the statutory requirement, and therefore could not avail itself of the privilege of filing a consolidated return. During 1954 taxpayer owned 74,000 shares of the common stock of Products, and there were between 118,900 and 120,000 common shares outstanding. A voting trust created in 1952 owned 30,000 shares, of which 2,000 were held for the benefit of taxpayer. Taxpayer thus owned approximately 62 per cent of Products' common stock, which was less than the amount required to entitle it to file a consolidated return with that company.

Taxpayer's contention that the voting trust as to 30,000 shares of Products' common stock was invalid under a 1953 Oregon statute limiting the duration of voting trusts, and that the trustee stock therefore was deprived of voting power, is without merit. The

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sioner has not appealed from this portion of the decision.

All issues with respect to the taxable year 1955 were settled by stipulation. Accordingly, the Tax Court sustained the Commissioner's determination of deficiencies in income tax in the amount of \$180,397.47 for 1955, and no question concerning the taxable year 1955 is in issue or review. (R. 4, 10.)



trust in question was created prior to the enactment of the Oregon statute, and as pointed out by the Tax Court, was not retrospectively invalidated by that legislation.

Even assuming that the voting trust had been terminated by the Oregon statute, it still would not follow, as taxpayer also assumes, that the voting rights inhering in the trustee shares disappeared. On the contrary, under the terms of the trust agreement, the trustees were required upon its termination to distribute the shares to the beneficial owners, who could then exercise the voting rights. Since the voting rights which attached to the trustee shares were exercisable *either* by the trustees or the beneficial owners—irrespective of whether (as taxpayer claims) the voting trust agreement was rendered invalid by the Oregon statute—there is no basis for taxpayer's contention that the rights must be disregarded for purposes of applying Code Section 1504 (a) (2).

Furthermore, taxpayer's entire argument rests upon the unwarranted premise that a dispute as to the ownership of outstanding shares of stock is tantamount to no ownership at all, i.e. non-existence of the stock, for purposes of applying Code Section 1504 (a) (2). As a condition precedent to the privilege of filing a consolidated return that section explicitly requires that the parent corporation own directly (1) stock possessing at least 80 per cent of voting power of the voting stock, plus (2) 80 per cent of each class of nonvoting stock. Under taxpayer's novel theory, any dispute as to ownership of any issued and outstanding shares of stock (voting or nonvoting) would

require disregard of those shares for purposes of determining whether the parent corporation owns the requisite percentage of both the voting and nonvoting stock. Clearly a dispute as to ownership of nonvoting shares would not operate to eliminate them from the total number of issued and outstanding shares for purposes of computing the percentage of nonvoting shares owned by the parent. *A fortiori*, a dispute as to who may exercise the voting rights with respect to outstanding voting stock cannot serve to eliminate such voting stock from the computation formula.

What is more, even assuming *arguendo* that the 30,000 shares in the voting trust are to be viewed as if the voting rights which attached to them were "suspended", and hence to be treated as nonvoting shares, as taxpayer asserts, taxpayer still could not prevail. For under its own reasoning such shares must then be classified as nonvoting shares, and taxpayer admittedly was the beneficial owner of 2,000 of such shares, or far less than the required 80 per cent of nonvoting stock.

## ARGUMENT

**Taxpayer Did Not Own Stock Possessing 80 Per Cent of the Voting Power of the Common Stock of Products and Hence Was Not Entitled To File a Consolidated Return With Products for 1954, Regardless of Whether the Voting Trust As To 30,000 of Products' Common Shares Was Valid or Invalid During That Year**

Section 1501 of the Internal Revenue Code of 1954 (Appendix, *infra*) provides that, subject to certain



limitations, an "affiliated group of corporations shall \* \* \* have the privilege of making a consolidated return" with respect to income taxes. An "affiliated group is defined in Section 1504 (Appendix, *infra*) as including only certain chains of corporations in which the common parent "owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock \* \* \*."

Throughout 1954 there were between 118,900 and 120,000 shares of the common stock of Products outstanding. Taxpayer owned 74,000 shares or approximately 62 per cent of this stock. A voting trust owned 30,000 shares of Products' common stock, 2,000 shares for the benefit of taxpayer. (R. 11, 16, 28-29.) Taxpayer admits (Br. 9) that during 1954 it owned less than 80 per cent of the outstanding shares of Products' common stock, and taxpayer does not claim that any of the shares were entitled to more than one vote.<sup>5</sup>

Taxpayer contends (Br. 5-17) that the voting trust was invalid or of doubtful validity under Oregon law, that the 30,000 shares of Products' common stock held in trust were deprived of voting rights, and that taxpayer's 74,000 shares, though less than 80 per cent of the outstanding 120,000 shares of com-

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<sup>5</sup> There were 5,000 shares of the preferred stock of Products outstanding at all times during 1954. The preferred stock does not possess voting rights and is limited and preferred as to dividends. (R. 28.) Section 1504 of the 1954 Code expressly provides that such preferred stock is not "stock" within the meaning of that section.



mon stock, possessed 80 per cent of the "voting power" of Products' common stock during 1954. On the facts of this case there is no merit in these contentions. Taxpayer did not own stock possessing 80 per cent of the voting power of Products' common stock in 1954 and consequently did not satisfy the requirements of Code Sections 1501 and 1504 for the privilege of filing a consolidated return with Products for 1954.<sup>6</sup>

**A. *The 1952 voting trust as to 30,000 shares of Products' common stock was valid throughout 1954, and the voting power of the trustee shares was unimpaired by Oregon legislation enacted in 1953***

The Tax Court correctly held (R. 19) that during 1954 the voting trust as to 30,000 shares of common stock of Products was not invalidated. The trust was created by agreement on November 3, 1952, for a period of twenty years, unless sooner terminated. (R. 11, 29, 34, 46.) Prior to the execution of the agreement the validity of voting trusts or pooling agreements had been recognized by the Oregon courts. *Curtze v. Iron Dyke Mining Co.*, 46 Or. 601, 81 Pac. 851; *In re Will of Pittock*, 102 Or. 159, 199

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<sup>6</sup> Taxpayer's claim (Br. 9) that it should be considered to have possessed 80 per cent of the voting power of Products' common stock during 1954 because of an alleged "pall of invalidity" over the voting trust is particularly inappropriate as a ground for claiming the "privilege" of filing a consolidated return. See *Commissioner v. Manus Muller & Co.*, 79 F. 2d 19, 20, certiorari denied, 296 U.S. 657 where Judge Learned Hand stated that " \* \* \* affiliation is a privilege in any case, akin to an exemption, and doubts go against the taxpayer."

Pac. 633; *Smith v. Bramwell*, 146 Or. 611, 31 P. 2d 647. Accordingly, as the Tax Court held (R. 17), the voting trust in issue was valid when executed.

There is no merit in taxpayer's contention that the voting trust was thereafter rendered invalid by Section 57.175 of the Oregon Revised Statutes (Appendix, *infra*), effective December 31, 1953. That Section provides:

*Voting trust.* Any number of shareholders of a corporation may create a voting trust for the purpose of conferring upon a trustee or trustees the right to vote or otherwise represent their shares, for a period of not to exceed 10 years, by entering into a written voting trust agreement specifying the terms and conditions of the voting trust, by depositing a counterpart of the agreement with the corporation at its registered office, and by transferring their shares to such trustee or trustees for the purposes of the agreement.

\* \* \*

On its face the terminology of Section 57.175 is permissive and does not render pre-existing voting trusts void or voidable. Under Oregon law legislation is interpreted as prospective in operation unless a retrospective application clearly is indicated by the terms of the statute. *Hartley v. Utah Const. Co.*, 106 F. 2d 953 (C.A. 9th).<sup>7</sup> Statutes similar to Sec-

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<sup>7</sup> In the *Hartley* case, 106 F. 2d 953, 955, this Court stated:

The rule in Oregon is:

"\* \* \* no act will be held to have a retrospective effect, unless the intention in that respect is clearly



tion 57.175 of the Oregon Revised Statutes have also been interpreted in other jurisdictions as applying only prospectively. See 5~~7~~ Fletcher, *Cyclopedia Corporations* (Perm. ed., 1952 Rev.), Sec. 2080.1:

The statutes usually limit \* \* \* duration [of voting trusts] to an arbitrary period, commonly 10 years, and are held to be prospective in operation, applying only to agreements entered into after their effective date.

For example, in *Wolf v. Roosevelt*, 290 N.Y. 400, 402, 49 N.E. 2d 502, the New York Court of Appeals gave only prospective effect to a statute which provided: "No agreement appointing trustees to vote the stock of any corporation \* \* \* shall be valid for a longer term than five years \* \* \*." In rejecting the argument that this statute limited the duration of pre-existing voting trusts, the Court of Appeals stated (290 N.Y. 400, 402, 403, 49 N.E. 2d 502, 503):

\* \* \* a statute restricting the power of individuals to create or define their rights should not be construed in a manner which would affect existing agreements unless the Legislature so provided in express terms or by plain implication.

\* \* \* The language of the statute is at least

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apparent in the statute itself. On the contrary, if it is fairly possible to restrain the operation of the statute so as to be prospective, that course will be adopted by the courts. \* \* \* " *Libby v. Southern Pac. Co.*, 109 Or. 449, 452, 219 P. 604, 605, 220 P. 1017.

See also *Hoffart v. Lindquist & Paget Mortg. Co.*, 182 Or. 611, 620, 189 P. 2d 592, 596.



inept if the Legislature intended that it should retroactively restrict the power of stockholders to enter into voting trust agreements.

\* \* \* If the statute is intended to apply to agreements already made those who entered into the agreement would be bound by limitations to which they did not agree, although they might never have consented to the plan of reorganization or the voting trust agreement if the agreement had been limited to five years from June, 1936.<sup>8</sup>

See also *Western Pac. R. Corp. v. Baldwin*, 89 F. 2d 269 (C.A. 8th), applying these principles of statutory construction and holding that provisions of Delaware law limiting the duration of voting trusts were inapplicable to pre-existing trusts. The same reasoning is applicable to the present case and supports the Tax Court's conclusion that the Oregon statute did not invalidate voting trusts entered into prior to its effective date, December 31, 1953.<sup>9</sup>

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<sup>8</sup> In *Wolf v. Roosevelt*, *supra*, the court rejected the suggestion that by implication the New York statute limited the duration of voting trusts to five years after its enactment. In the present case the taxpayer makes the more extreme contention that the voting trust became invalid on the effective date of the statute limiting its duration. *A fortiori*, this position is inconsistent with *Wolf v. Roosevelt*, *supra*. The voting trust involved in the instant case would be valid during 1954 even if retrospectively limited in duration to ten years from its inception or from the effective date of the Oregon voting trust statute.

<sup>9</sup> In the present case the taxpayer's assertion that Section 57.175 should be applied retroactively to suspend the voting power of shares held by previously existing non-complying trusts would have practical results which the legislature un-

Furthermore, Section 57.799 of the Oregon Revised Statutes (Appendix, *infra*), expressly provides that no right, liability or penalty created under the prior Act should be affected by its repeal, thus indicating that the legislature intended only prospective operation of the new statute. This general intention is not inconsistent with the statement in Section 57.796, (Appendix, *infra*), relied upon by taxpayer (Br. 6-7), that "The provisions of the Oregon Business Corporation Act shall apply \* \* \* to all existing corporations organized under any general Act of this state." Both general expressions of legislative intention may be observed by the prospective application of the new statute to existing corporations. Thus the terms of the statute, applicable authority and principles of statutory construction, and the indicia of legislative intention all demonstrate that Section 57.175 applies only prospectively and did not invalidate the pre-existing trust as to 30,000 shares of Products' common stock during 1954.

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doubtedly did not intend. Taxpayer suggests (Br. 14) that if the majority of the voting stock of a corporation were held by a trust such as that in issue, control of the corporation and all its assets would pass to a minority interest, however small, until such time as the trust was terminated by agreement among all parties or by specific judicial decree. It does not appear likely that the legislature intended that Section 57.175, limiting the duration of voting trusts, should be applied retrospectively to create any such possible distortion of the control and management of corporations.



**B. *Regardless of the validity of the voting trust, taxpayer did not satisfy the Internal Revenue Code requirements of stock ownership for the privilege of filing a consolidated return with Products for 1954***

Even if the pre-existing voting trust were deemed terminated by reason of the enactment of the 1953 Oregon statute, there would have been no impairment of the voting rights of the trustee shares.

To begin with, the trust agreement specifically provides (R. 46) :

11. Term Of Agreement And Distribution of Common Stock Upon Termination. \* \* \* After common stock has been deposited under this agreement such common stock cannot be withdrawn until this agreement is terminated unless the Trustees in their discretion by written statement release a portion of the common stock held hereunder \* \* \*.

Within sixty days after the termination of this agreement the Trustees shall deliver to the registered holders of all voting trust certificates, certificates for the number of shares of common stock represented by the voting trust certificates, upon surrender thereof, properly endorsed.

If the voting trust had been terminated by operation of law, the trustees would have been obligated to distribute the trustee common stock of Products to the beneficial owners and the voting rights of the stock would not have been destroyed even temporarily.<sup>10</sup>

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<sup>10</sup> In the event of such a distribution, taxpayer would have held 2,000 trustee shares in addition to its 74,000 shares, still less than 80 per cent of the 120,000 outstanding common shares.



Furthermore, and again assuming *arguendo* that the voting trust was rendered invalid by the 1953 Oregon statute, there are additional and alternative reasons for sustaining the decision below.

Under Section 1504 of the 1954 Code, to file a consolidated return a parent corporation must own directly "stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock" of a subsidiary. The term "stock" does not include nonvoting preferred stock. Section 1504 imposes no requirements with respect to the ownership of stock of the subsidiary which is held by persons other than the parent corporation.

In essence, the taxpayer's contention is that the amount of Products' voting stock which Section 1504 requires that it own to file a consolidated return should be reduced because of alleged doubt as to the ownership of some shares admittedly not owned by taxpayer. Applied as a general proposition, taxpayer's interpretation of Section 1504(a)(2) would mean that any dispute as to ownership of any issued and outstanding shares of stock (voting or nonvoting) would require disregard of those shares for purposes of determining whether the parent corporation owns the requisite percentage of both voting and nonvoting stock. Clearly such an interpretation of Section 1504 is erroneous, for, contrary to the express terms of the statute, it would make qualification to file a consolidated return depend upon ownership by the parent of *less* than 80 per cent of the issued and outstanding stock. By the same token, the existence

of a dispute as to who may exercise the voting power of particular shares of stock does not require disregard of those shares in determining whether a parent corporation is qualified to file a consolidated return. The elimination of stock from the computation of the stock ownership requirements for filing a consolidated return on the basis of a dispute as to ownership or voting rights would unrealistically distort the requirements imposed by Section 1504 of the 1954 Code.<sup>11</sup>

Moreover, in this case to treat the 30,000 trustee shares of Products' common stock as deprived of voting power during 1954 would be contrary to the provisions of Oregon law which control the voting rights of the stock of that corporation. With respect to the voting power of corporate stock Section 57.170 of the Oregon Revised Statutes (Appendix, *infra*) provides:

*Voting of shares.* (1) Each outstanding share, regardless of class, shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders, except to the extent that the

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<sup>11</sup> For example, if a corporation owned only 10 percent of each class of the stock of a second corporation, and a dispute arose as to the ownership of the remaining 90 percent of each class of stock, under taxpayer's theory the dominant interest should be ignored and the corporations should be qualified to file consolidated returns on the basis that the "parent's" 10 percent interest constituted all the outstanding shares of each class of stock of the second corporation. Clearly in such a case the stock ownership requirements of Section 1504 would not be satisfied.



voting rights of the shares of any class or classes are limited or denied by the articles of incorporation as permitted by this chapter.

Taxpayer does not contend that the voting rights of the common stock of Products are "limited or denied" by that company's articles of incorporation. Section 57.170 further states:

(2) Neither treasury shares, nor shares of its own stock held by a corporation in a fiduciary capacity, nor shares held by another corporation if a majority of the shares entitled to vote for the election of directors of such other corporation is held by the corporation, shall be voted at any meeting or counted in determining the total number of outstanding shares at any given time.

\* \* \* \*

(6) \* \* \* Shares standing in the name of a trustee may be voted by him, either in person or by proxy; but no trustee shall be entitled to vote shares held by him without a transfer of such shares into his name.

The 30,000 shares of Products' common stock held in trust during 1954 clearly were not within any of the categories of shares limited as to voting power by paragraph (2). Since those shares had been transferred into the name of the trustees (R. 28-29), under the terms of paragraph (6) the trustees were entitled to vote them. Thus Section 57.170, which is concerned with the voting rights of corporate stock and the limitations on the voting power of certain shares, imposes no limitation on the voting power of the shares in issue. Taxpayer has not indicated any



other provision of Oregon law which limits the voting power of shares owned by a voting trust in 1954. Instead, taxpayer simply alleges doubt under Oregon law as to validity of a voting trust, and asserts that because of such alleged doubt the trustee shares were deprived of voting rights during 1954. As indicated above, the applicable Oregon statutes contain no provisions for such a limitation upon the voting power of corporate stock but on the contrary state that each share of a corporation's stock "shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders" in the absence of conditions not present in this case. In short, whether or not the voting trust was valid, the trustee shares themselves possessed voting rights, exercisable by either the trustee or the beneficial owners.

Even in cases where the owners of corporate shares were temporarily unable to exercise their voting rights, contentions similar to those of the taxpayer properly have been rejected because the shares themselves remained voting stock.

In *Doernbecher Mfg. Co. v. Commissioner*, 80 F. 2d 573 (C.A. 9th), the taxpayer subsidiary claimed the privilege of filing a consolidated return under Section 141(d), Revenue Act of 1928, although the parent did not own the required 95 per cent of the voting stock of the allegedly affiliated subsidiary.<sup>12</sup> Tax-

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<sup>12</sup> The Revenue Act of 1928, c. 852, 45 Stat. 791, 831, defined "affiliated group" for consolidated return purposes as including certain chains of corporations in which—

(2) The common parent corporation owns di-

payer had entered into an agreement to purchase shares of its own stock; the stock had been placed in escrow under an agreement that the seller had no right to vote or draw dividends on the shares while in escrow; and taxpayer claimed the shares were treasury stock and should be excluded from stock to be considered in arriving at the 95 per cent ownership requirement for affiliation. This Court held, 80 F. 2d 573,<sup>575</sup> that the escrowed stock “\* \* \* was still voting stock even if the right of the seller to vote it was temporarily suspended” and that the corporations were not affiliated and might not file a consolidated return.

In *Kansas, O. & G. Ry. Co. v. Helvering*, 124 F. 2d 460 (C.A. 3d), after termination of a voting trust, some of the trust receipts were not turned in for stock certificates. The court held that the unclaimed voting stock for which trust receipts were not surrendered must be included in the total of the voting stock in determining whether the parent corporation had the 95 per cent ownership required for qualification to file a consolidated return.<sup>13</sup> The court stated (124

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rectly at least 95 per centum of the stock of at least one of the other corporations.

As used in this subsection the term “stock” does not include nonvoting stock which is limited and preferred as to dividends.

<sup>13</sup> The Revenue Act of 1932, c. 209, 47 Stat. 169, 213, Sec. 141(d), contains provisions identical to those of the Revenue Act of 1928 (footnote 12, *supra*) defining “affiliated group” for consolidated return purposes. The definition is unchanged in the Revenue Act of 1934, c. 277, 48 Stat. 680, 721, Sec. 141(d), except for the addition of provisions limiting the privilege to railroad corporations.



F. 2d 460, 464):

Nor is it of any consequence that the trust receipt holders cannot vote the stock to which they are entitled until stock certificates therefor have been issued to them. The stock is voting stock none the less. It is the voting privilege with which a particular stock issue is endowed and not whether it is voted which determines its voting character within the intent of Section 141 of the Revenue Act of 1932 and 1934.

See also *Pioneer Parachute Co. v. Commissioner*, 6 T.C. 1246, affirmed, 162 F. 2d 249 (C.A. 2d).<sup>14</sup>

Taxpayer attempts (Br. 10-11) to distinguish these authorities on the ground that the 1954 Code requires

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<sup>14</sup> In the *Pioneer Parachute* case a subsidiary had issued shares of new non-voting preferred stock to minority shareholders in exchange for their voting stock. The new preferred stock was convertible into common stock at the shareholder's option and paid two-thirds of common stock dividends. The applicable statute, Section 730(d) of the Internal Revenue Code of 1939, as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974 (26 U.S.C. 1952 ed., Sec. 730) (applicable to excess profits taxes for years beginning before 1942), stated as one of the requirements for affiliation that:

(2) The common parent corporation owns directly at least 95 per centum of each class of the stock of at least one of the other includible corporations.

As used in this subsection the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

The Tax Court held that the preferred stock of the subsidiary must be treated as voting stock and that it was not entitled to join with its parent in filing a consolidated return.



for affiliation that the parent corporation own "stock possessing at least 80 percent of the voting power" whereas prior law required ownership of "at least 95 percentum of each class of stock".<sup>15</sup> The distinction is not valid. In fact, the statutes involved in *Dornbecher Mfg. Co. v. Commissioner*, *supra*, and *Kansas, O. & G. Ry. Co. v. Helvering*, *supra* (footnotes 12 and 13), required that the common parent own directly "at least 95 per centum of the stock" and in each case the applicable statute provides that the term "stock" does not include nonvoting preferred stock.

In *Anderson-Clayton Securities Corp. v. Commissioner*, 35 B.T.A. 795, the taxpayer owned 100 per cent of the preferred shares and 64 per cent of the common shares of each of six subsidiaries. The preferred stock had voting power of 50 votes per share and the common had one vote per share. The Board held this satisfied the affiliation requirement of Section 141(d) of the Revenue Act of 1928, *supra*, that the common parent own "at least 95 per centum of the stock" as the statute was concerned with ownership of "stock" rather than number of "shares". See also I.T. 3896, 1948-1 Cum. Bull. 72, to the effect that the affiliation requirements in Section 141 of the Internal Revenue Code of 1939 (and Section 1504 of the 1954 Code) in terms of "voting power" follow the *Anderson-Clayton* decision.

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<sup>15</sup> The latter terminology is from Section 730(d), Internal Revenue Code of 1939, *supra*, involved in the *Pioneer Parachute* case, *supra*.

Thus, even where the voting power of the owners of shares is temporarily unexercisable, the shares are considered in determining whether a taxpayer owns stock possessing sufficient voting power to satisfy the requirements for filing a consolidated return. A contrary rule would amount to an invitation to avoid the consolidated return prerequisites by the simple device of temporary suspension of voting rights of the owners of some shares.<sup>16</sup>

In addition, in the present case taxpayer would not qualify to file a consolidated return with Products even if, in accordance with its contentions, the 30,000 trustee shares were not considered to have voting power in 1954. By taxpayer's own reasoning, in such case the trustee shares would then constitute a class of nonvoting common stock. The taxpayer, as beneficial owner of 2,000 of the 30,000 shares, would not satisfy the separate requirement of Section 1504 that it own 80 per cent of such class of nonvoting stock.

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<sup>16</sup> See *Atlantic City Co. v. Commissioner*, 288 U.S. 152, 154, to the effect that Congress sought "to prevent evasion through the manipulation of intercompany transactions" in the statutes establishing affiliation requirements for the filing of consolidated returns.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

Respectfully submitted,

JOHN B. JONES, JR.,  
*Acting Assistant Attorney General.*

LEE A. JACKSON,  
HARRY BAUM,  
NORMAN H. WOLFE,  
*Attorneys,*  
*Department of Justice,*  
*Washington 25, D. C.*

October, 1961.



## APPENDIX

## Internal Revenue Code of 1954:

## SEC. 1501. PRIVILEGE TO FILE CONSOLIDATED RETURNS.

An affiliated group of corporations shall, subject to the provisions of this chapter, have the privilege of making a consolidated return with respect to the income tax imposed by chapter 1 for the taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all the consolidated return regulations prescribed under section 1502 prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(26 U.S.C. 1958 ed., Sec. 1501.)

## SEC. 1504. DEFINITIONS.

(a) *Definition of "Affiliated Group".*—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

- (1) Stock possessing at least 80 percent of the voting power of all classes of stock

and at least 80 percent of each class of the nonvoting stock of each of the includible corporations (except the common parent corporation) is owned directly by one or more of the other includible corporations; and

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

\* \* \* \*

(26 U.S.C. 1958 ed., Sec. 1504.)

### Oregon Revised Statutes:

Section 57.170 *Voting of shares.* (1) Each outstanding share, regardless of class, shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders, except to the extent that the voting rights of the shares of any class or classes are limited or denied by the articles of incorporation as permitted by this chapter.

(2) Neither treasury shares, nor shares of its own stock held by a corporation in a fiduciary capacity, nor shares held by another corporation if a majority of the shares entitled to vote for the election of directors of such other corporation is held by the corporation, shall be voted at any meeting or counted in determining the total number of outstanding shares at any given time.



(3) A shareholder may vote either in person or by proxy executed in writing by the shareholder or by his duly authorized attorney-in-fact. No proxy shall be valid after 11 months from the date of its execution, unless otherwise provided in the proxy.

(4) At each election for directors every shareholder entitled to vote at such election shall have the right to vote, in person or by proxy, the number of shares owned by him for as many persons as there are directors to be elected and for whose election he has a right to vote, or, if the articles of incorporation specifically permit cumulative voting, to cumulate his votes either by giving one candidate as many votes as the number of such directors multiplied by the number of his shares shall equal or by distributing such votes on the same principle among any number of such candidates.

(5) Shares standing in the name of another domestic or foreign corporation may be voted by such officer, agent or proxy as the bylaws of such corporation may prescribe, or, in the absence of such provision, as the board of directors of such corporation may determine.

(6) Shares held by an administrator, executor, guardian or conservator may be voted by him, either in person or by proxy, without a transfer of such shares into his name. Shares standing in the name of a trustee may be voted by him, either in person or by proxy; but no trustee shall be entitled to vote shares held by him without a transfer of such shares into his name.

(7) Shares standing in the name of a receiver may be voted by such receiver, and shares held



by or under control of a receiver may be voted by such receiver without the transfer thereof into his name if authority so to do be contained in an appropriate order of the court by which such receiver was appointed.

(8) A shareholder whose shares are pledged shall be entitled to vote such shares until the shares have been transferred into the name of the pledgee, and thereafter the pledgee shall be entitled to vote the shares so transferred.

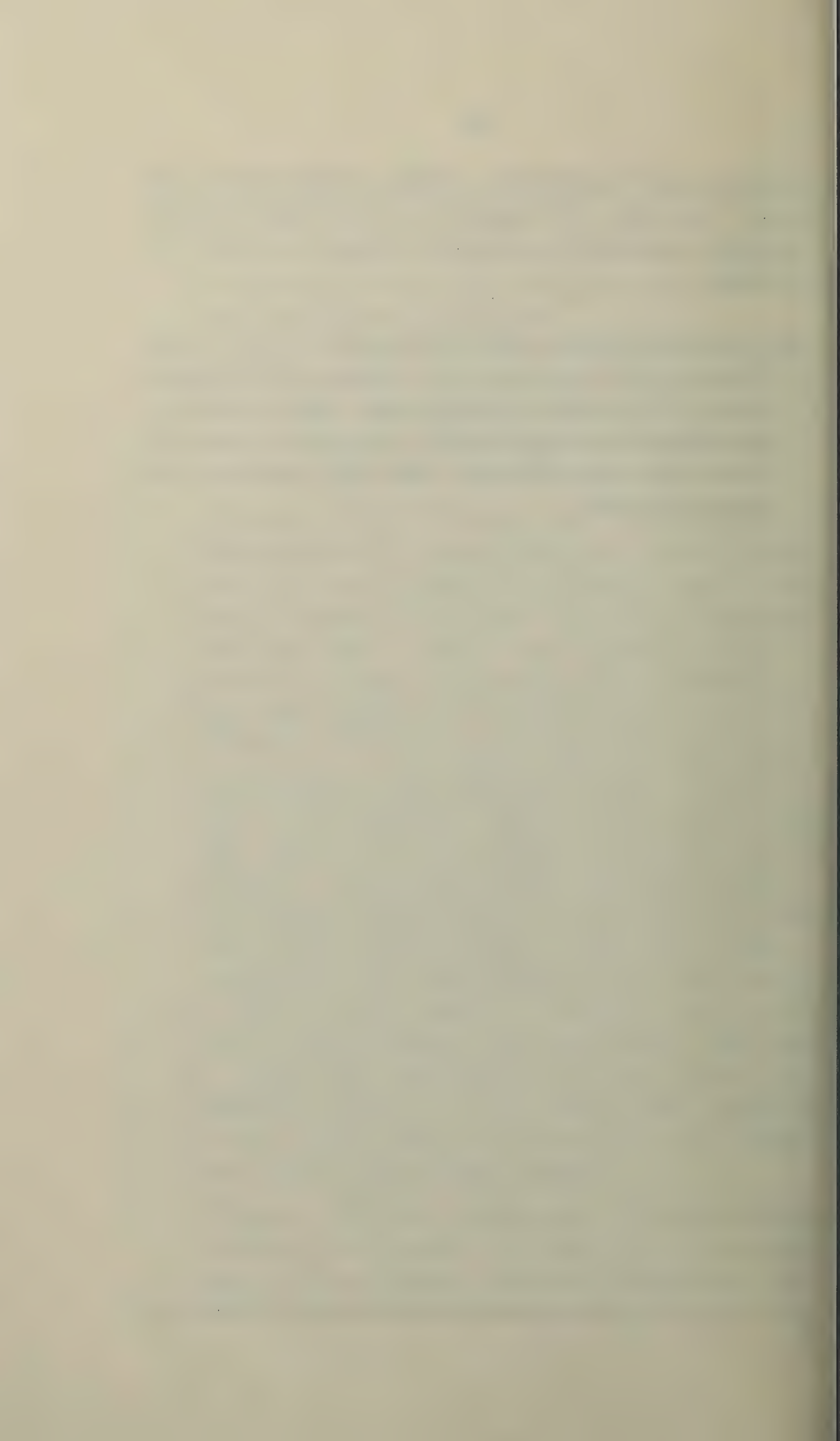
Section 57.175 *Voting trust.* Any number of shareholders of a corporation may create a voting trust for the purpose of conferring upon a trustee or trustees the right to vote or otherwise represent their shares, for a period of not to exceed 10 years, by entering into a written voting trust agreement specifying the terms and conditions of the voting trust, by depositing a counterpart of the agreement with the corporation at its registered office, and by transferring their shares to such trustee or trustees for the purposes of the agreement. The counterpart of the voting trust agreement so deposited with the corporation shall be subject to the same right of examination by a shareholder of the corporation, in person or by agent or attorney, as are the books and records of the corporation, and shall be subject to examination by any holder of a beneficial interest in the voting trust, either in person or by agent or attorney, at any reasonable time for any proper purpose.

Section 57.796 *Application to corporations existing on December 31, 1953.* (1) The provisions of the Oregon Business Corporation Act shall apply to the fullest extent permitted by the

laws and Constitution of the United States and of the State of Oregon, to all existing corporations organized under any general Act of this state.

\* \* \* \*

Section 57.799 *Effect of repeal of prior Acts.*  
The repeal of a prior Act by chapter 549, Oregon Laws 1953, shall not affect any right accrued or established, or any liability or penalty incurred, under the provisions of such Act, prior to the repeal thereof.





No. 17361

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United States  
Court of Appeals  
for the Ninth Circuit

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STANDARD LUMBER CO., formerly PILOT  
ROCK LUMBER CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

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Transcript of Record

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Petition to Review a Decision of the  
Tax Court of the United States

FILED

JUL 31 1961

FRANK M. SCHMIDT, CLERK



No. 17361

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**United States  
Court of Appeals  
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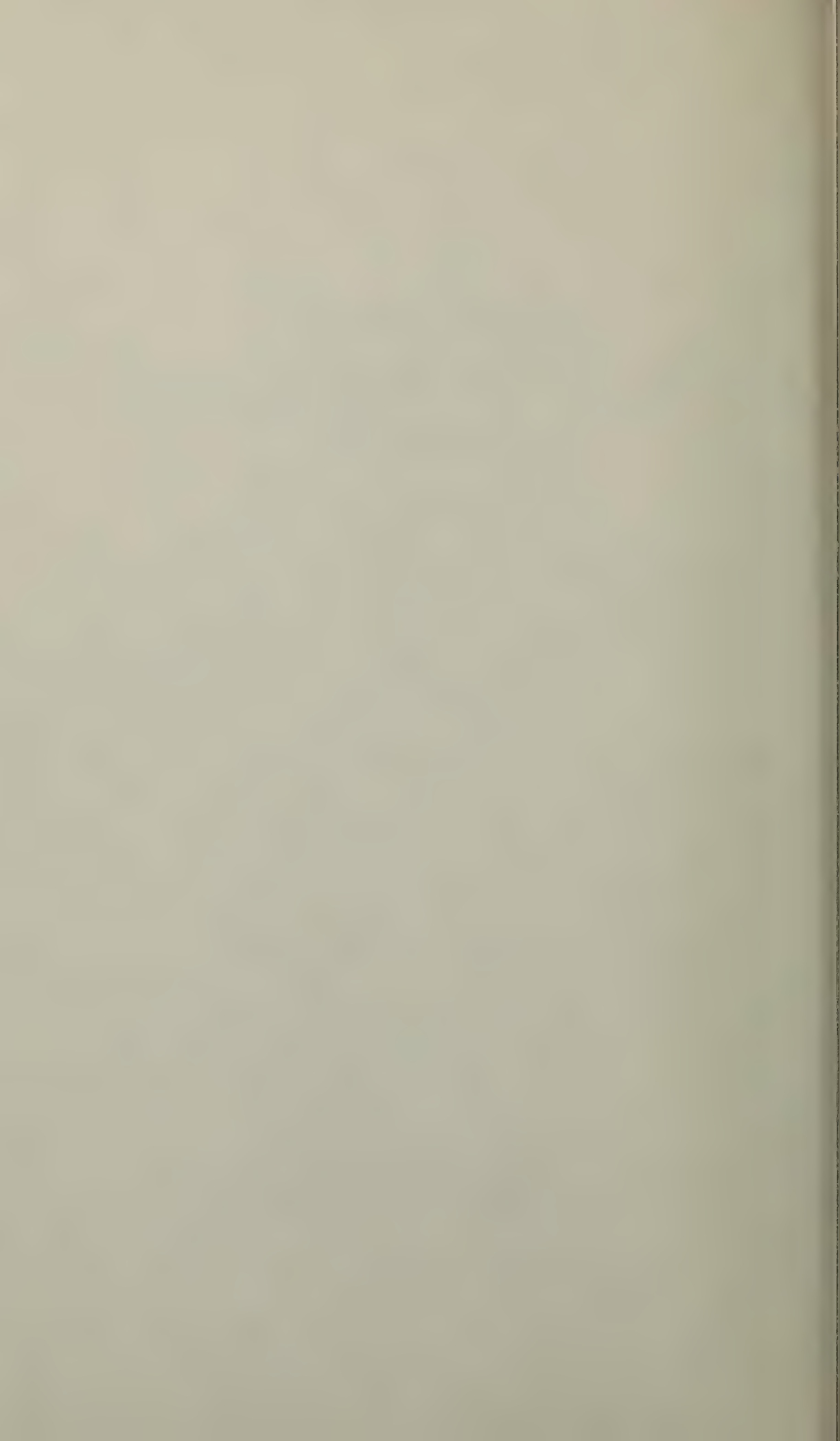
**Transcript of Record**

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**Petition to Review a Decision of the  
Tax Court of the United States**

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## INDEX

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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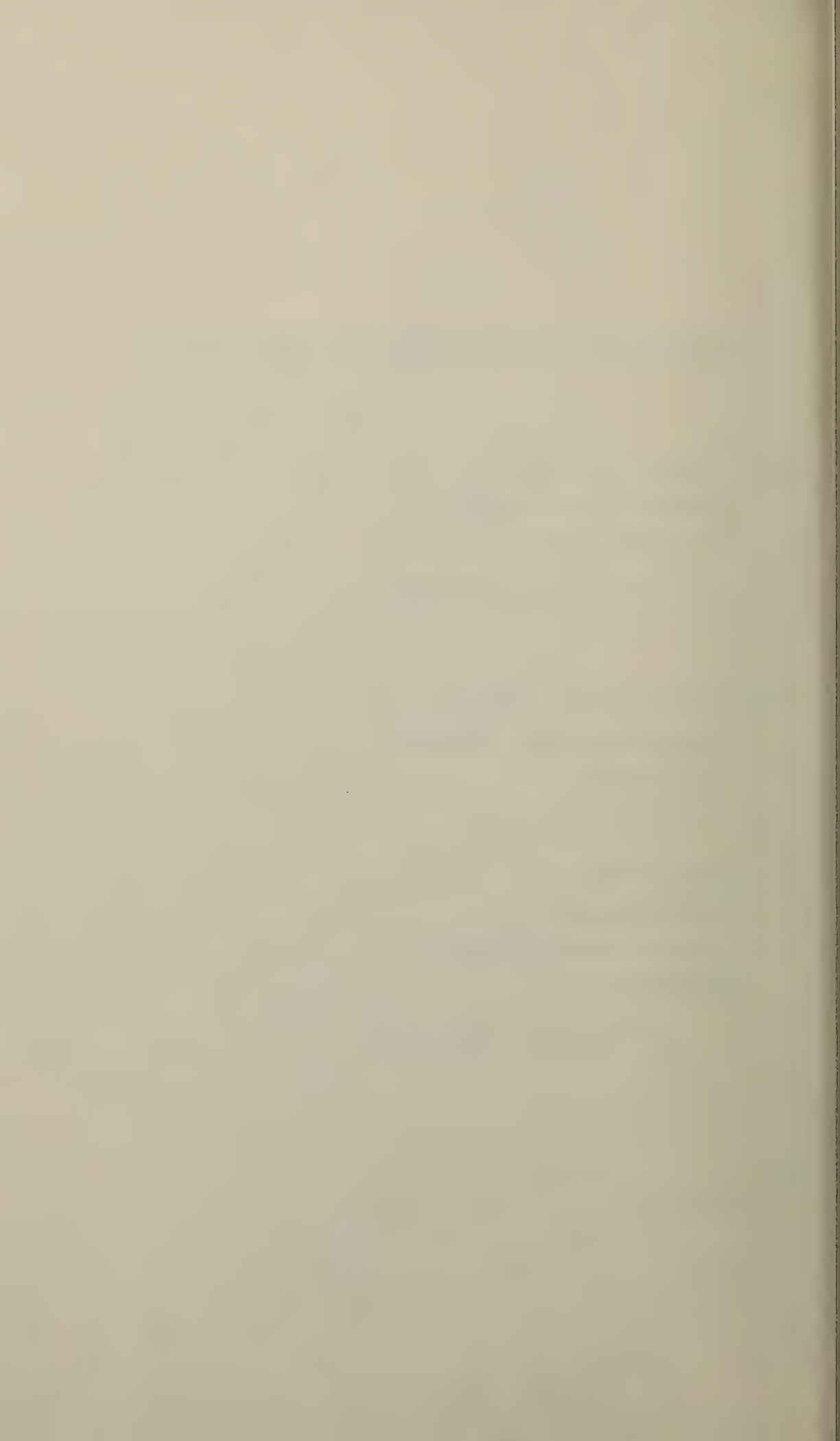


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## Tax Court of the United States

Docket No. 77900

STANDARD LUMBER CO., formerly PILOT  
ROCK LUMBER CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.RESPONDENT'S COMPUTATION FOR ENTRY  
OF DECISION

The attached computation is submitted, on behalf of the respondent, in compliance with the Court's opinion determining the issues in this case.

This computation is submitted without prejudice to respondent's right to contest the correctness of the decision entered herein by the Court, pursuant to the statute in such cases made and provided.

/s/ HART H. SPIEGEL, JDP  
Chief Counsel,  
Internal Revenue Service.

## Of Counsel:

Melvin L. Sears,  
Regional Counsel,  
Walter I. Auran,  
Attorney,  
Internal Revenue Service,  
484 Pittock Block,  
Portland 5, Oregon.

Without prejudice to the right of appeal, it is agreed



that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled case.

/s/ WILLIAM H. KINSEY,  
Counsel for Petitioner.

ARC-Ap:SF:P:FES

Computation Statement  
Rule 50

In re: Standard Lumber Co., formerly  
Pilot Rock Lumber Co.  
Pilot Rock, Oregon  
Docket No. 77900

Taxable Years Ending December 31, 1954 and December 31, 1955

Income Tax

<u>Year</u>	<u>Deficiency</u>
1954	\$208,092.16
1955	180,397.47
Total	<u>\$388,489.63</u>

Details supporting the above computations are set forth in the attached pages.

Standard Lumber Co., formerly  
Pilot Rock Lumber Co.

Rule 50 Computation Statement

Taxable Year Ended December 31, 1954

## Schedule 1

## Adjustment to Taxable Income

Taxable income disclosed by statutory notice of deficiency dated September 11, 1958	\$857,988.01
As adjusted	<u>765,973.01</u>
Adjustment, reduction	<u><u>\$(92,015.00)</u></u>
Reduction:	
1. Interest income	<u><u>\$ 92,015.00</u></u>

## Schedule 1(a)

## Explanation of Adjustment

1. The opinion of The Tax Court of the United States promulgated October 31, 1960, is that the postponed interest for 1954 on the debentures of Oregon Fibre Products, Inc. did not constitute accrued interest taxable to petitioner in 1954. Therefore, taxable income is decreased by \$92,015.00. It is further held that during 1954 petitioner did not own stock in Oregon Fibre Products, Inc. possessing 80% of the voting power so as to entitle it to file a consolidated return with Oregon Fibre Products, Inc.

## Schedule 2

## Computation of Tax—1954

Taxable income as adjusted	\$765,973.01
Less excess of net long-term capital gain over net short-term capital loss	710,437.75
Balance	<u>\$ 55,535.26</u>
Partial tax (52% of \$55,535.26 minus \$5,500.00)	\$ 23,378.34
Plus 26% of \$710,437.75	184,713.82
Total Tax Liability	\$208,092.16
Assessed—Account No. 957111	None
Deficiency	\$208,092.16
Standard Lumber Co., formerly Pilot Rock Lumber Co.	

## Rule 50 Computation Statement

Taxable Year Ended December 31, 1955

## Schedule 3

## Adjustment to Taxable Income

Taxable income disclosed by statutory notice of deficiency dated September 11, 1958	\$632,221.86
As adjusted	541,659.98
Adjustment, reduction	<u>\$ 90,561.88</u>
Reduction:	
1. Consolidation	<u><u>\$ 90,561.88</u></u>



## Schedule 3(a)

## Explanation of Adjustment

1. It is agreed, by stipulation of facts dated March 10, 1960, that petitioner and Oregon Fibre Products, Inc. are entitled to file a consolidated return for the entirety of the calendar year 1955. It is further agreed by stipulation of facts that the deduction of \$50,000.00 with respect to amortization of Masonite Licenses claimed by Oregon Fibre Products, Inc. in the consolidated return filed for the calendar year 1955 was properly disallowed in the statutory notice of deficiency. Therefore, income is decreased by \$90,561.88 computed as follows:

Net loss reported by Oregon Fibre Products, Inc. per 1955 consolidated return (exclusive of contributions in the amount of \$220.00)	\$443,512.92
Less disallowance of amortization on Masonite Licenses	50,000.00
Loss of Oregon Fibre Products, Inc. for 1955 as adjusted	<hr/> \$393,512.92
Loss allowed per statutory notice of deficiency	<hr/> 302,951.04
Adjustment	<hr/> <hr/> \$ 90,561.88

## Schedule 4

## Computation of Tax—1955

Taxable income as adjusted	\$541,659.98
Less excess of net long-term capital gain over net short-term capital loss	<u>721,589.87</u>
Balance	<u>\$ None</u>
Partial tax	\$ None
Plus 25% of \$721,589.87	<u>180,397.47</u>
Total tax liability	<u>\$180,397.47</u>
Assessed—Account No. CN-84-56	<u>None</u>
Deficiency	<u><u>\$180,397.47</u></u>

Received and Filed Dec. 21, 1960.

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[Title of Tax Court and Cause.]

Filed October 31, 1960.

Docket No. 77900

1. Petitioner held 62 per cent of the outstanding stock of P corporation and trustees under a voting trust held 25 per cent. The voting trust was created in 1952 to continue for 20 years. A state law enacted in 1953 provided that voting trusts could be created for periods not to exceed 10 years. The trust was terminated by consent of the parties in 1955. Held: the state legislative enactment worked no suspension of the voting rights of the stock held in trust; petitioner did not own stock of P corporation possessing 80 per cent of the voting power in 1954 so as to entitle petitioner and P to file a consolidated return.

2. Petitioner held debentures of P corporation which bore 5 per cent interest payable semiannually. Petitioner entered a consent to modification of the indenture and a standby agreement so as to allow P corporation to postpone payment of the interest until full payment of a loan and interest to the RFC. Held, postponed interest for 1954 on the debentures of P corporation did not constitute accrued income taxable to petitioner in 1954.

William H. Kinsey, Esq., for the petitioner.

Walter I. Auran, Esq., for the respondent.



## OPINION.

Black, Judge: Respondent has determined deficiencies in the income tax of petitioner for the years 1954 and 1955 as follows:

<u>Year</u>	<u>Deficiency</u>
1954	\$255,939.96
1955	180,397.47

All issues relating to the taxable year 1955 have been settled in the stipulation filed by the parties. Respondent conceded that petitioner was entitled to file a consolidated income tax return with Oregon Fibre Products, Inc., hereinafter referred to as Products, for the year 1955. Petitioner conceded that Products was not entitled to a deduction of \$50,000 on amortization of masonite. Effect will be given to this agreement under Rule 50.

Two issues as to the year 1954 are presented:

1. Whether petitioner owned directly stock of Products possessing at least 80 per cent of the voting power so as to entitle the two corporations to file a consolidated income tax return under the provisions of section 1504 (a)(2) of the Internal Revenue Code of 1954.

2. Whether, if it be determinated that the corporations were not entitled to file a consolidated return, interest in the amount of \$92,015 on debentures of Products held by petitioner constituted accrued income taxable to petitioner.

The facts, all of which are stipulated, are included herein by this reference and may be summarized as follows:

Petitioner, formerly Pilot Rock Lumber Co., is a dissolved and liquidated corporation which was organized under the laws of the State of Oregon and had its principal office at Pilot Rock, Oregon. Liquidation of petitioner was completed on June 30, 1956. Products was incorporated under the laws of the State of Oregon, likewise having its principal office at Pilot Rock. Petitioner and Products maintained their books and reported income on an accrual method of accounting by calendar years, and timely filed a consolidated income tax return for 1954 with the district director of internal revenue, Portland, Oregon.

During 1954, Products had two classes of authorized stock, common and preferred. The preferred stock did not possess voting rights and was limited and preferred as to dividends. During the same year, petitioner held approximately 62 per cent of Products' outstanding common stock, trustees under a voting trust agreement held approximately 25 per cent, and all others held approximately 13 per cent.

The voting trust agreement under which the trustees held approximately 25 per cent of stock of Products outstanding during 1954 was created on November 3, 1952, and terminated by consent of all parties thereto by an agreement dated January 1, 1955. The voting trust agreement empowered the trustees to vote all the shares of Products held under the agreement. It further provided that the trust agreement should continue for 20 years from its date.

Section 57.175 of the Oregon Revised Statutes, a part of the Oregon Business Corporation Act which

was passed during the 1953 session of the Oregon legislature and became effective December 31, 1953, provides that a voting trust can be created for a period not to exceed 10 years.

On or about January 1, 1952, Products issued \$2,500,000 of 5 per cent sinking fund debentures. Petitioner purchased and held \$1,840,000 of these debentures. The debentures read, in material part, as follows:

Oregon Fibre Products, Inc. \* \* \* promises to pay \* \* \* on January 1, 1968 \* \* \* the principal sum \* \* \* and to pay interest thereon at the rate of five per cent (5%) per annum\* \* \* semi-annually on the 1st day of July and the 1st day of January in each year, until payment of said principal sum has been made or duly provided for, subject to the limitation set forth in the next paragraph in regard to the postponement of interest payments. \* \* \*

Interest shall accrue on this Debenture from the applicable date specified in the preceding paragraph, but payment of such interest may be postponed by the Company in the event, to the extent and during the period that payment of interest on the Debentures is prevented by the terms or operation of any loan, or any modification thereof, senior to the Debentures obtained by the Company (either before or after the date of the Indenture) from the Reconstruction Finance Corporation or from any other lender, public or private, for the purpose of financing the construction program under which the Company built and equipped or will build and equip its fiberboard plant. Such postponement of interest payments shall not constitute an Event of De-



fault as defined in the Indenture unless and until the Company does not pay such postponed interest on or before the third interest payment date following the date of the termination of any obstacle to the payment of such interest created by any such loan senior to the Debentures, but such postponed interest shall be paid in any event on or before January 1, 1958, and failure to pay such postponed interest, if any, on or before January 1, 1958, constitutes an Event of Default. Accrued interest, the payment of which is postponed in accordance with the foregoing, shall not be due within the meaning of any of the provisions of this Debenture or the Indenture until such time as the postponement of such interest constitutes an Event of Default.

On or about December 31, 1953, petitioner executed a "consent" with regard to the debentures of Products which read, in material part, as follows:

The undersigned holder \* \* \* Of Oregon Fibre Products, Inc. Debentures \* \* \* hereby consents to the execution of a Supplemental Indenture containing the provisions set forth below. \* \* \*

(a) Notwithstanding any other provisions of this Indenture, including but not limited to the Events of Default and other provisions contained in Article Six of the Indenture, no principal or interest shall become due and payable upon the Consenting Debenture until the R.F.C. Loan has been fully paid. Until such time the Trustee shall take no action under the Indenture with respect to declaring the principal of any of the Consenting Debentures due and payable, or any other action which might otherwise be taken with respect to the preservation or protection of the rights of the Con-

senting Debentures. Any interest, the payment of which is postponed under the preceding sentence, shall be paid on or before the third interest payment date following the date upon which the R.F.C. Loan is fully paid, and failure to pay such postponed interest on or before such third interest payment date shall constitute an Event of Default. For the purposes hereof the R.F.C. Loan shall have been fully paid upon the date specified in written notice of such payment delivered to the Trustee by the R.F.C or by the substitute obligor in the event the R.F.C Loan has been refinanced.\* \* \*

On or about December 31, 1953, petitioner also executed a "standby agreement" with respect to debentures of Products which read, in material part, as follows:

To induce the Reconstruction Finance Corporation (herein called "RFC") to make further disbursements of all or any part of the loan (herein called "Loan"), authorized to Oregon Fibre Products, Inc., \* \* \* Borrower, ..... (herein called "Debenture Holder") hereby represent, warrant and covenant \* \* \* to and with each other and with the RFC with respect to the indebtedness \* \* \* owing by Borrower to Debenture Holder \* \* \* that:

1. Without the prior written consent of RFC, Debenture Holder will take no action to assert, collect or enforce all or any part of the Debenture.

2. Debenture Holder will promptly pay to RFC all amounts which may be received by Holder on account of the Debenture.

\* \* \* \* \*

4. Debenture Holder will deliver to the Trustee under the Debentures or to Borrower and the Trustee or the Borrower will stamp or otherwise mark each Debenture with a legend as follows:

This Debenture and all rights represented thereby are subject to all the terms and conditions of a certain Standby Agreement made by and between the Debenture Holder and the RFC \* \* \* which Standby Agreement provides, among other things, that the Company shall not pay any interest or principal on this Debenture Bond until payment in full of the RFC Loan in the amount of \$3,100,000.00 together with interest has been made \* \* \*

\* \* \* \* \*

7. This Standby Agreement and all obligations hereunder or with respect hereto, of Borrower and Debenture Holder, shall continue in full force and effect until payment in full of the indebtedness evidenced by the Note, notwithstanding any action which RFC or Borrower, or others, with the consent of RFC may take or refrain from taking with respect to such indebtedness.\* \* \*

On or about January 7, 1954, the legend specified in the standby agreement was stamped on all of the debentures which petitioner held.

Products made no payments of interest to consenting debenture holders, including petitioner, during any of the periods here in question. In the Federal income tax return filed by petitioner for the calendar year 1954, interest on the debentures of Products was included in the amount of \$92,015.



The first issue presented is whether petitioner and Products were entitled to file a consolidated return for the year 1954 under the provisions of section 1504-(a)(2) of the 1954 Code.<sup>1</sup> Petitioner concedes that if all of the 120,000 outstanding shares of Products' common stock are counted, its 74,000 shares constitute a holding insufficient to qualify for the privilege of filing a consolidated return. It insists, however, that the voting rights of 30,000 shares under the voting trust agreement were suspended by operation of the Oregon Business Corporation Act during 1954, and that, therefore, its 74,000 shares possessed not 62 but 82 per cent of the voting power of all classes of stock. Respondent contends that no suspension of the voting rights of the stock held under the voting trust was worked by enactment of the Oregon Business Corporation Act, and that, therefore, petitioner did not own stock in Products possessing 80 per cent of the voting power during the taxable year 1954.

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<sup>1</sup>Sec. 1504. Definitions.

(a) Definition of "Affiliated Group."—As used in this chapter, the term "affiliated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is an includible corporation if—

\* \* \* \* \*

(2) The common parent corporation owns directly stock possessing at least 80 percent of the voting power of all classes of stock and at least 80 percent of each class of the nonvoting stock of at least one of the other includible corporations.

As used in this subsection, the term "stock" does not include nonvoting stock which is limited and preferred as to dividends.

Prior to the enactment of the Oregon Business Corporation Act, the validity of voting trusts had been recognized by the courts of that state. *Curtze v. Iron Dyke Copper Min. Co.*, 81 Pac. 815. See also, *In re Pittock's Will*, 199 Pac. 633; *Smith v. Bramwell*, 31 P. 2d 647. The trust agreement was entered into on November 3, 1952. By its terms the voting trust was to continue for a period of 20 years. It is not contended nor do we find any warrant for holding that the agreement was not valid when executed.

In 1953, the Oregon legislature enacted a Business Corporation Act which provided that voting trusts might be created "for a period of not to exceed 10 years." Petitioner contends that the enactment cast "[a] definite pall of invalidity" upon the voting trust. Its position is stated in its brief, thus:

Pending judicial clarification of the impact of this statutory provision upon a pre-existing voting trust, the voting trustees could not validly exercise their voting rights under the voting trust. Neither could the voting trust certificate holders exercise same until the stock was issued in their names. In the absence of a judicial determination, the matter could be resolved only through a mutual termination of the voting trust agreement. \* \* \*

We do not agree that the voting trustees could not exercise their voting rights. The rights and liability of the parties under the voting trust agreement attached prior to the enactment. For the Oregon Business Corporation Act to invalidate the trust or suspend any rights accruing thereunder would require the retrospec-

tive application of the act. As was set forth in *Hartley v. Utah Const. Co.*, 106 F. 2d 953, at p. 955:

The rule in Oregon is:

“\* \* \* no act will be held to have a retrospective effect, unless the intention in that respect is clearly apparent in the statute itself. On the contrary, if it is fairly possible to restrain the operation of the statute so as to be prospective, that course will be adopted by the courts. \* \* \*”

*Libby v. Southern Pac. Co.*, 109 Or. 449, 452, 219 Pac. 604, 605, 220 Pac. 1017.

See also *Hoffart v. Lindquist*, 189 P. 2d at 592, 596, in which it is stated that “[i]t is well settled that legislation is usually construed as prospective and not retrospective.” We are not directed to, nor do we find, any provision of the act which would indicate that the Oregon legislature intended retrospective application of the act. Indeed, section 57.799 of the act, by providing that no right, liability or penalty created under the prior act should be affected by its repeal, indicates that the legislature intended only prospective operation of the act.

Both parties have discussed cases arising in jurisdictions other than Oregon to buttress their contentions. At least one case, *Christopher v. Richardson* (1959), 394 Pa. 425, 147 A. 2d 375, cited by petitioner is wholly inapplicable in that it involves a voting trust created after passage of the act restricting the duration of such trusts. More appropriate to the present issue are *Wolf v. Roosevelt*, 290 N. Y. 400, 49 N. E. 2d 502, and *Western Pac. R. Corporation v. Baldwin*,



89 F. 2d 269, in both of which cases it was concluded that acts limiting the duration of voting trusts were not to be applied to pre-existing trust agreements in jurisdictions recognizing the validity of such trusts at their creation.

We are satisfied that the voting trust in the present case was not invalidated by enactment of section 57.175 of the Oregon Business Corporation Act, and that there was no concomitant suspension of the voting rights of the 30,000 shares so held in trust. We hold, therefore, that during 1954, petitioner did not own stock in Products possessing 80 per cent of the voting powers so as to entitle it to file a consolidated return with Products.

The second issue presented is whether interest, in the amount of \$92,015, on debentures issued by Products and held by petitioner is properly includible in petitioner's income for the year 1954. Petitioner accrued the interest on its books for 1954 and prior years, but contends that such accrual was erroneous for 1954 in that payment of the interest was contingent upon payment of the RFC loan. Petitioner relies solely on the contingency which it claims arises from the modification of the trust indenture, debentures, and the standby agreement with the RFC and Products. Respondent maintains that petitioner in 1954 had a fixed and unconditional right to the interest although payment of the interest was postponed.

In *San Francisco Stevedoring Co.*, 8 T. C. 222, at p. 225, we set forth the principles of law applicable to a determination of the proper accrual of income as follows:

A taxpayer, using an accrual method of accounting, must accrue an item in the year in which the taxpayer acquires a fixed and unconditional right to receive the amount, even though actual payment is to be deferred. There must be no contingency or unreasonable uncertainty qualifying the payment or receipt. Income does not accrue to a taxpayer using an accrual method until there arises in him a fixed or unconditional right to receive it. \* \* \*

The debentures as issued provided for postponement of interest payments in favor of the RFC loan, but the payments were required to be made no later than January 1, 1958. The debentures were, thus, similar to those involved in *Natco Corporation v. United States*, 240 F. 2d 398, a case cited on brief by both parties. Were we presented with an issue involving only the debentures as originally issued, we should have no difficulty sustaining respondent's determination. The situation would be substantially the same as it was in the *Natco Corporation* case.

Petitioner, however, consented to an amendment of the trust indenture, entered into a standby agreement with Products and the RFC, and suffered the alteration of the debentures in accordance with the agreement and consent. By the consent and standby agreement, petitioner relinquished its right to receive payment of principal or interest on the bonds until the RFC loan was fully paid, renounced its right to assert claims under or enforce the debentures, and agreed to pay over to the RFC any sums received under the debentures. Thus petitioner's right to receive payment of interest on the debentures was dependent upon full pay-

ment by Products of the principal and interest of the RFC loan. If any item is to accrue as income, "[t]here must be no contingency \* \* \* qualifying the payment or receipt." San Francisco Stevedoring Co., cited and quoted *supra*.

We hold, therefore, that a contingency so qualified petitioner's right to receipt of the interest here in issue as to render it not properly includible in petitioner's income for the year 1954.

Decision will be entered under Rule 50.

Served Nov. 1, 1960.

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Tax Court of the United States

Docket No. 77900

STANDARD LUMBER CO., formerly PILPOT  
ROCK LUMBER CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

### DECISION

Pursuant to the opinion of the Court filed October 31, 1960, and the agreed computation of the tax liabilities filed by the parties; and incorporating herein the facts recited in the computation as the findings of the Court, it is



Ordered and Decided: That there are deficiencies in income tax due from the petitioner for the taxable years 1954 and 1955 in the amounts of \$208,092.16 and \$180,397.47, respectively.

/s/ EUGENE BLACK,  
Judge.

\* \* \* \* \*

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the agreed computation of the parties, and that the Court may enter this decision, without prejudice to the right of either party to contest the correctness of the decision entered herein, pursuant to the statute in such cases made and provided.

/s/ WILLIAM H. KINSEY,  
Counsel for Petitioner.

[Seal]

/s/ HART H. SPIEGEL,  
Chief Counsel,  
Internal Revenue Service.

Entered Dec. 27, 1960.

Served Dec. 29, 1960.

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[Title of Tax Court and Cause.]

## PETITION FOR REVIEW

Taxpayer, petitioner herein, by William H. Kinsey, counsel, hereby files its petition for review by the United States Court of Appeals for the Ninth Circuit, of the decision of the Tax Court of the United States on December 27, 1960, 35 T.C. ...., No. 24, determining deficiencies in the petitioner's Federal Income Taxes for the taxable years 1954 and 1955 in the amounts of \$208,092.16 and \$180,397.47, respectively, and respectfully shows:

### I.

The petitioner, Standard Lumber Co., formerly Pilot Rock Lumber Co., is a dissolved and liquidated corporation which prior to its dissolution was incorporated under the laws of the State of Oregon, having its principal office at Pilot Rock, Oregon.

That petitioner's Federal Income Tax Returns for the taxable years 1954 and 1955 were made to the Collector of Internal Revenue, or the District Director of Internal Revenue for the District of Oregon; the United States Court of Appeals for the Ninth Circuit is the proper court to review the aforesaid decision of the Tax Court of the United States, by virtue of Section 7482(b)(1) of the Internal Revenue Code of 1954.

### II.

#### Nature of the Controversy

The controversy involves the proper determination of petitioner's liability for Federal Income Taxes for the taxable years 1954 and 1955. This in turn de-

pendes upon whether or not the petitioner and Oregon Fibre Products, Inc., an Oregon corporation (hereinafter referred to as "Oregon Fibre") were entitled to file a consolidated income tax return for the calendar year 1954 under the provisions of Section 1504(a)(2) of the Internal Revenue Code of 1954, and more specifically, whether or not petitioner at all times during the calendar year 1954 owned stock of Oregon Fibre possessing at least 80% of the voting powers.

At all times during the calendar year 1954 there were issued and outstanding no more than 120,000 shares of the common stock of Oregon Fibre. Petitioner owned 74,000 of such shares and 30,000 of such shares were held by voting trustees under a 20 year voting trust agreement dated November 3, 1952. In 1953 the Oregon Legislature passed a law, to be effective December 31, 1953, that a voting trust agreement could be created for a period not to exceed ten years (ORS 57.175). On January 1, 1955, by mutual agreement, the voting trust agreement dated November 3, 1952, was terminated.

Petitioner took the position that the 30,000 shares subject to the voting trust were divested of voting power by the passage of ORS 57.175 since a "pall of invalidity" was thereby placed over said trust and that neither the trustees or equitable owners thereof had the right to vote said shares pending a judicial determination of the effect of ORS 57.175 on the validity of said voting trust. Therefore, petitioner, relying on its ownership of 74,000 of the remaining 90,000 shares of Oregon Fibre or 82% thereof, filed a consoli-



dated return with Oregon Fibre for the calendar year 1954.

The Commissioner of Internal Revenue took the position that the 30,000 shares subject to said voting trust were shares with voting power and that, therefore, petitioner did not own at least 80% of the voting power of the Oregon Fibre stock and was thus not entitled to file a consolidated return with Oregon Fibre for the calendar year 1954. Because of this determination, the Commissioner recomputed petitioner's tax liability for the calendar years 1954 and 1955 and determined income tax deficiencies against petitioner as follows:

1954 .....	\$255,939.96
1955 .....	180,397.47

The opinion of the Tax Court of the United States affirmed the findings of the Commissioner of Internal Revenue that petitioner was not entitled to file a consolidated return for the calendar year 1954, and held that ORS 57.175 worked no suspension of the voting rights of the stock held in trust and that petitioner did not own stock of Oregon Fibre possessions at least 80% of the voting power in 1954 so as to entitled petitioner and Oregon Fibre to file a consolidated return for that year. Thereafter, the Tax Court entered its decision under Rule 50 determining deficiencies in income tax due from the petitioner for the taxable years 1954 and 1955 in the amounts of \$208,092.16 and \$180,397.47, respectively.

## III.

The petitioner, being aggrieved by the conclusions of law contained in the opinion of the Tax Court of the United States that petitioner was not entitled to file a consolidated return for the calendar year 1954, and being aggrieved by the decision of the Tax Court entered pursuant thereto, desires to obtain a review thereof by the United States Court of Appeals for the Ninth Circuit.

/s/ WILLIAM H. KINSEY,  
Counsel for Petitioner,  
1001 Board of Trade Building,  
Portland 4, Oregon.

State of Oregon, County of Multnomah—ss.

William H. Kinsey, being first duly sworn, says: That he is the counsel of record in the above-named cause; that as such counsel he is authorized to verify the foregoing petition for review; that he has read the said petitioner and is familiar with the statements contained therein; that the statements made are true to the best of his knowledge, information and belief.

/s/ WILLIAM H. KINSEY,

Subscribed and sworn to before me this 20th day of March, 1961.

/s/ JOHN B. SOUTHERN,  
[Seal] Notary Public for Oregon.  
My Commission Expires Oct. 21, 1963.

Affidavit of Service by Mail Attached.

Received and Filed March 23, 1961.

[Title of Tax Court and Cause.]

### STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel of record, that the following facts are true, and the same may be so considered and accepted by the court as offered in evidence by the parties; provided, however, that this stipulation is without prejudice to the right of either party to object to the materiality or relevancy of the facts hereinafter set forth:

1. Standard Lumber Co., formerly Pilot Rock Lumber Co., the petitioner herein, is a dissolved and liquidated corporation which prior to its dissolution was incorporated under the laws of the State of Oregon having its principal office at Pilot Rock, Oregon. The statement of intent to dissolve petitioner was filed with the Oregon Corporation Commissioner on June 27, 1956. Immediately prior to the filing of such statement of intent to dissolve, articles of amendment were filed with the Corporation Commissioner changing the name of petitioner from Pilot Rock Lumber Co. to Standard Lumber Co. so that petitioner was dissolved and liquidated under the name of Standard Lumber Co. The articles of dissolution for petitioner under the name of Standard Lumber Co. were filed with the Oregon Corporation Commissioner on July 17, 1956. The liquidation was completed on June 30, 1956. Under ORS Section 57.630 of the Oregon Business Corporation Act any action or proceeding by or against a desolved corporation may be prosecuted or defended by the corporation in its corporate name, and the Directors and of-



ficers have power to take such corporate action as shall be appropriate to protect such remedy, right or claim.

2. The books of petitioner were maintained and its Federal income tax returns were prepared on the accrual basis of accounting by calendar years.

3. Oregon Fibre Products, Inc. was incorporated under the laws of the State of Oregon, having its principal office at Pilot Rock, Oregon. Oregon Fibre Products, Inc. maintained its books and filed its Federal income tax returns on the accrual basis of accounting by calendar years.

4. Oregon Fibre Products, Inc. had two classes of authorized stock, preferred and common. There were 5,000 shares of the preferred stock outstanding at all times during the calendar year 1954. The preferred stock does not possess voting rights and is limited and preferred as to dividends. As of January 1, 1954, of the authorized shares of common stock of Oregon Fibre Products, Inc. there were 118,900 shares issued and outstanding, held as follows:

Pilot Rock Lumber Co.	74,000
E. C. Kerns, A. W. Moltke and Calvin N. Souther, Trustees under Voting Trust Agreement dated November 3, 1952	30,000
All other individuals	<u>14,900</u>
	118,900

As of December 31, 1954, all of the 120,000 shares of authorized common stock of Oregon Fibre Products, Inc. was issued and outstanding, held as follows:

Pilot Rock Lumber Co.	74,000
E. C. Kerns, A. W. Moltke and Calvin N. Souther, Trustees under Voting Trust Agreement dated November 3, 1952	30,000
All other individuals	16,000
	<hr/> 120,000

At all times during the calendar year 1954 there were issued and outstanding no more than 120,000 shares of the common stock of Oregon Fibre Products, Inc. At all times during the calendar year 1954 the petitioner owned 74,000 of such shares and 30,000 of such shares were held in the names of the voting trustees.

5. The Voting Trust under which the voting trustees held the 30,000 shares of common stock of Oregon Fibre Products, Inc. was created on November 3, 1952 pursuant to agreement, a copy of which is attached hereto as Exhibit 1-A. At all times subsequent to the creation of the Voting Trust, until terminated by agreement on January 1, 1955 hereinafter mentioned, the common stock of Oregon Fibre Products, Inc. issued to and held by the voting trustees was for the benefit of and for shares as follows:

Pilot Rock Lumber Co.	2,000
Harvey Gunderson	6,000
Carver Investment Company	22,000
	<hr/> 30,000

6. During the 1953 session of the Oregon legislature, an Act entitled "Oregon Business Corporation Act" was passed which was approved by the Governor on May 2, 1953 and filed in the office of the Secretary of State on May 4, 1953. This Act became Chapter 549 of Oregon Laws, 1953, which, by its terms, was to become effective on December 31, 1953. Section 32 of the Act, now Sec. 57.175 of Oregon Revised Statutes, provides that a voting trust can be created for a period not to exceed ten years. By agreement dated January 1, 1955 between Oregon Fibre Products, Inc., an Oregon corporation; E. C. Kerns, A. W. Moltke and Calvin N. Souther as Trustees of the voting trust; Pilot Rock Lumber Co., an Oregon corporation; Harvey J. Gunderson and Carver Investment Company, the voting trust created on November 3, 1952 was terminated.

7. Pursuant to the terms of an Indenture of Trust dated January 1, 1952 between Oregon Fibre Products, Inc. and The United States National Bank of Portland (Oregon), \$2,500,000 of Sinking Fund Debentures, bearing interest at 5% per annum, were issued by Oregon Fibre Products, Inc. on or about January 1, 1952. The Debentures were in the form of the attached Exhibit 2-B. Petitioner purchased, and, subsequent to its acquisition, held \$1,840,300 of the 5% Sinking Fund Debentures of Oregon Fibre Products, Inc.

8. On or about December 31, 1953 certain holders (but not all) of Oregon Fibre Products, Inc. Debentures executed a Consent to Amendment of Oregon



Fibre Products, Inc. Indenture which was in the form of the attached Exhibit 3-C. Petitioner executed such a Consent with respect to the \$1,840,300 of Oregon Fibre Products, Inc. Debentures held by it. On or about December 31, 1953 certain holders (but not all) of Oregon Fibre Products, Inc. Debentures executed a Standby Agreement with Oregon Fibre Products, Inc. which was in the form of the attached Exhibit 4-D. Petitioner executed such a Standby Agreement with respect to the \$1,840,300 of Oregon Fibre Products, Inc. Debentures held by it.

9. On January 7, 1954, Oregon Fibre Products, Inc. and The United States National Bank of Portland (Oregon) executed a Supplemental Indenture containing the provisions set forth in the attached Exhibit 3-C. On or about January 7, 1954, a legend was stamped on the face of each Debenture held by all parties executing the Consent to Amendment of Oregon Fibre Products, Inc. Indenture and the Standby Agreement, which legend was in the form set forth under paragraph 4 of the Standby Agreement. (Exhibit 4-D). Such a legend was stamped on all of the \$1,840,300 of Oregon Fibre Products, Inc. Debentures held by petitioner.

10. Oregon Fibre Products, Inc. made payments of the 5% interest on its Debentures to all non-consenting Debenture holders. No payments of interest were made to consenting Debenture holders. Oregon Fibre Products, Inc. accrued on its books interest at 5% with respect to all Debentures held by parties, including petitioner, executing consents and standby agree-

ments. In all Federal income tax returns filed by Oregon Fibre Products, Inc. deductions were claimed for all of the 5% interest, both paid and accrued.

11. Both prior to and during the calendar year 1954, petitioner accrued on its books interest computed at 5% on the \$1,840,300 of Oregon Fibre Products, Inc. Debentures it held, and included such amounts in its Federal income tax returns. In the Federal income tax return filed by petitioner for the calendar year 1954, accrued interest with respect to the \$1,840,300 of Oregon Fibre Products, Inc. Debentures was included in the amount of \$92,015.00.

12. On September 16, 1955, a U. S. corporation income tax return in the form of a consolidated return for the calendar year 1954, a copy of which is attached hereto as Exhibit 5-E, was filed by petitioner and Oregon Fibre Products, Inc. with the District Director of Internal Revenue at Portland, Oregon. On May 11, 1956, a U. S. corporation income tax return in the form of a consolidated return for the calendar year 1955 was filed by petitioner and Oregon Fibre Products, Inc. with the District Director of Internal Revenue at Portland, Oregon. Both of such returns were timely filed pursuant to extensions of time granted. A statutory notice of deficiency for the calendar years 1954 and 1955 was mailed to petitioner on September 11, 1958.

13. Should it be decided that petitioner and Oregon Fibre Products, Inc. are entitled to file a consolidated income tax return for the calendar year 1954, then and in that event there would be a consolidated

net operating loss for 1954 of \$500,651.77 which would qualify without modification as a consolidated net operating loss deduction allowable with respect to the consolidated income tax return of petitioner and Oregon Fibre Products, Inc. for the calendar year 1955. In addition, there would be unused charitable contributions for the calendar year 1954 of \$2,331.25 which would qualify as charitable contributions carryover to the consolidated return for the calendar year 1955, subject only to the 5% limitation.

14. It is stipulated that petitioner and Oregon Fibre Products, Inc. are entitled to file a consolidated return for the entirety of the calendar year 1955.

15. It is further stipulated that the deduction of \$50,000.00 with respect to amortization of masonite licenses claimed by Oregon Fibre Products, Inc. in the consolidated return filed for the calendar year 1955 has been properly disallowed as to such year by the respondent.

/s/ WILLIAM H. KINSEY,  
Counsel for Petitioner,  
Tenth Floor, Board of Trade Bldg.  
Portland 4, Oregon.

/s/ HART H. SPIEGEL,  
Chief Counsel,  
Internal Revenue Service.

Filed March 15, 1960.

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## EXHIBIT 1-A

## Voting Trust Agreement

Voting Trust Agreement made and entered into on or as of the 3rd day of November, 1952, between Oregon Fibre Products, Inc., an Oregon corporation (hereinafter referred to as the "Company"; and E. C. Kerns, A. W. Moltke and Calvin N. Souther (hereinafter referred to as the "Trustees"); and Pilot Rock Lumber Co., an Oregon corporation, common stockholder of the Company, and the common stockholders of the Company who may hereafter become parties hereto (Pilot Rock Lumber Co. and such other common stockholders being hereinafter referred to as the "Stockholders"),

Witnesseth:

Whereas, the common stock of the Company, par value \$1.00 per share (hereinafter referred to as the "common stock") is the only stock of the Company having voting power; and

Whereas, the Stockholders deem it necessary and advisable and for their best interest in order to secure continuity and stability of policy and management of the Company, to deposit with the Trustees the common stock owned by them; and

Whereas, the Trustees have consented to act under this agreement for the purposes herein provided;

Now, therefore, it is hereby agreed as follows:

1. Transfer of Stock to the Trustees. Pilot Rock Lumber Co., the stockholder executing this agreement, shall forthwith deposit with the Trustees certificates

representing 2,000 shares of common stock. Pilot Rock Lumber Co. and any other stockholders of the Company, may at any time hereafter deposit additional certificates for common stock with the Trustees, but no stockholder shall be required to deposit common stock hereunder unless the stockholder elects to do so. All such common stock certificates deposited with the Trustees hereunder shall be so endorsed, or accompanied by such instrument of transfer, as to enable the Trustees to cause such certificates to be transferred into the names of the Trustees. All certificates for common stock transferred and delivered to the Trustees hereunder shall be surrendered by the Trustees to the Company and cancelled, and new certificates therefor shall be issued in the name of the Trustees and delivered to them, whereupon the Trustees shall deliver to the Stockholders voting trust certificates for the common stock deposited by them. The Trustees shall hold in accordance with the terms hereof all common stock for which voting trust certificates are issued hereunder.

2. Scope of Agreement. Every person, firm or corporation receiving any voting trust certificate issued hereunder shall be bound by the provisions of this agreement with the same effect as if they had executed any amendments thereto, shall be filed in the office of the Company at Pilot Rock, Umatilla County, Oregon, and shall be open daily during business hours to the inspection of any voting trust certificate holder and any stockholder of the Company.

3. Voting Trust Certificates. The voting trust certificates to be issued and delivered by the Trustees in respect of the common stock as hereinbefore provided shall be in substantially the following form:

No. \_\_\_\_\_ Shares

Oregon Fibre Products, Inc.

Voting Trust Certificate for Common Stock

This certifies that \_\_\_\_\_ or registered assigns, is entitled to all of the benefits arising from the deposit with the Trustees under the voting trust agreement dated \_\_\_\_\_, 1952 of certificates for the above indicated shares of common stock of Oregon Fibre Products, Inc., an Oregon corporation, hereinafter called the "Company". This certificate and the holders hereof are subject to all of the terms and conditions of said voting trust agreement, copies of which are on file and may be inspected at the office of the Company in Pilot Rock, Umatilla County, Oregon, and the holder of this certificate is bound with like effect as if said voting trust agreement had been signed by the holder hereof.

The registered holder hereof, or assigns, is entitled to receive any and all dividends (except stock dividends) received by the Trustees upon the shares of common stock of the Company represented by this certificate. Dividends received by the Trustees in common or other stock of the Company having general voting powers shall be payable in voting trust certificates in form similar hereto. As provided in said voting trust agreement, the Trustees have and are entitled to exercise all voting rights in respect of the common stock of the



Company represented by this certificate, and no voting right whatsoever passes to the holder hereof, or assigns, except the right specified in said voting trust agreement to designate successor Trustees in the event successor trustees are not designated by the remaining trustees or the board of directors of the Company.

This certificate and any shares represented hereby are transferable on the books of the Trustees at the office of the Trustees (which office is the same as the office of the Company) by the holder hereof, either in person or by attorney duly authorized in accordance with the rules established for that purpose by the Trustees. The holder hereof agrees that delivery of this certificate, duly endorsed by the holder, shall vest title in the transferee; provided, that the Trustees may treat the registered holder hereof, or when presented duly endorsed in blank the bearer hereof, as the absolute owner hereof for all purposes whatsoever, and the Trustees shall not be bound or affected by any notice to the contrary. As a condition to making or permitting any transfer or delivery of voting trust certificates or common stock represented thereby, the Trustees may require the payment of a sum sufficient to pay, reimburse, and indemnify the Trustees for any stamp tax or other governmental charge in connection therewith.

This certificate shall not be valid for any purpose until duly signed by all of the Trustees or any two of them.

The word "Trustees" as used in this certificate means the original Trustees executing said voting trust agreement and any successor Trustee or Trustees acting under voting trust agreement.

In witness whereof the Trustees have signed this certificate on\_\_\_\_\_.

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

(Form of Assignment)

Trustees

For value received \_\_\_\_\_ hereby transfers and assigns unto \_\_\_\_\_ all rights in respect of \_\_\_\_\_ shares of the common stock of the Company represented by the within voting trust certificate, and hereby irrevocably constitute and appoint \_\_\_\_\_ attorney to transfer this certificate (or so much thereof as represents the number of shares of common stock of the Company transferred and assigned hereby) on the books of the Trustees, with full power of substitution.

Dated \_\_\_\_\_ (Seal)

4. Transfer of Certificates. Each voting trust certificate and all rights thereunder in respect of any number of the shares of (common) stock represented thereby shall be transferable at the office of the Trustees (which shall be the same as the office of the Company in Pilot Rock, Umatilla County, Oregon), on the books of the Trustees, by the registered holder thereof, whether in person or by attorney thereto duly authorized, upon surrender thereof according to rules established for that purpose by the Trustees. The Trustees shall not be required to recognize any transfer of a voting trust certificate not made in accordance with

the provisions hereof, unless the person claiming such ownership shall have produced indicia of title satisfactory to the Trustees, and shall in addition deposit with the Trustees indemnity satisfactory to them. The Trustees may treat the registered holder of any voting trust certificate as the owner thereof for all purposes whatsoever but the Trustees shall not be required to deliver common stock certificates upon termination of this agreement without surrender of any voting trust certificate or certificates representing such stock.

If a voting trust certificate is lost, stolen, mutilated or destroyed, the Trustees in their discretion may issue a duplicate of such certificate upon receipt of: (a) evidence of such fact satisfactory to them, (b) indemnity satisfactory to them, (c) the existing certificate if mutilated, and (d) their reasonable fees and expenses in connection with the issuance of a new trust certificate.

5. Dividends. The holders of the voting trust certificates shall be entitled to receive, and the Trustees shall pay to them, any and all dividends (except stock dividends provided for in the next sentence) received by the Trustees upon the shares of common stock represented by the voting trust certificates. If any dividend is paid by the Company, in whole or in part, in common stock or other stock of the Company having general voting powers, the Trustees shall hold, subject to the terms hereof, the certificates for such stock which are received by them on account of such stock dividend, and the holders of each voting trust certificate representing stock on which such stock dividend has been paid shall be entitled to receive a voting trust



certificate issued under this agreement for the number of shares received as such stock dividend. Holders entitled to receive the dividends discussed above shall be those registered as such on the transfer books of the Trustees at the close of business on the day fixed by the Company for the taking of a record to determine those holders of its stock entitled to receive such dividends.

In lieu of receiving dividends and paying the same to the holders of voting trust certificates pursuant to the preceding paragraph, the Trustees may instruct the Company in writing to pay such dividends to the holders of the voting trust certificates. Upon receipt of such written instructions the Company shall pay such dividends directly to the holders of the voting trust certificates. Upon such instructions being given by the Trustees to the Company, and until revoked by the Trustees, all liability of the Trustees with respect to such dividends shall cease. The Trustees may at any time revoke such instructions and by written notice to the Company direct it to make dividend payments to the Trustees.

6. **Subscription Rights.** In case any stock or other securities of the Company are offered for subscription to the holders of common stock deposited hereunder, the Trustees, promptly upon receipt of notice of such offer, shall mail a copy thereof to each of the holders of the voting trust certificates. Upon receipt by the Trustees, at least five days prior to the last day fixed by the Company for subscription and payment, of a request from any such registered holder of voting trust certificates to subscribe in his behalf, accompanied with the

sum of money required to pay for such stock or securities (not in excess of the amount subject to subscription in respect of the shares represented by the voting trust certificates held by such certificate holder), the Trustees shall make such subscription and payment, and upon receiving from the Company the certificates for shares or securities so subscribed for, shall hold, subject to the terms hereof, the certificates of such stock which are received by them on account of such subscription and shall issue to such holder a voting trust certificate in respect thereof if the same be common stock or other stock having general voting powers, but if the same be securities other than common stock or other stock having general voting power, the Trustee shall mail or deliver such securities to the certificate holder in whose behalf the subscription was made, or may instruct the Company to make delivery directly to the certificate holder entitled thereto.

7. Dissolution of Company. In the event of the dissolution or total or partial liquidation of the Company, whether voluntary or involuntary, the Trustees shall receive the moneys, securities, rights or property to which the holders of the common stock deposited hereunder are entitled, and shall distribute the same among the registered holders of voting trust certificates in proportion to their interests, as shown by the books of the Trustees, or the Trustees may in their discretion deposit such moneys, securities, rights, or property with any bank or trust company doing business in Portland, Oregon, with authority and instructions to distribute the same as above provided, and upon such deposit all further obligations or liabilities of the



Trustees in respect of such moneys, securities, rights, or property so deposited shall cease.

8. Reorganization of Company. The term "reorganization" used herein means the merger of the Company into another corporation or the merger of another corporation into the Company, the consolidation of the Company with another corporation or corporations, the transfer of all or substantially all of the assets of the Company to another corporation, the acquisition by the Company of the assets of another corporation, the recapitalization of the Company, or any combination of the foregoing. In the event of a reorganization of the Company, the term "Company" for all purposes of this agreement shall include any successor or component corporation in such reorganization. Subject to the provisions of paragraph 9 granting voting trust certificate holders the right to have their common stock appraised and paid for upon certain sales, mergers or consolidations, the voting Trustees may exchange in any reorganization all or any part of the common stock held hereunder for stock or securities of any successor or component corporation or of the Company, and the Trustees shall receive and hold under this agreement any common stock (or other stock having general voting rights) of any successor or component corporation or of the Company received on account of or in exchange for all or any part of the common stock held hereunder. Voting trust certificates issued and outstanding under this agreement at the time of the reorganization shall after the reorganization represent the number of shares of common stock specified in the voting trust certificates less any shares transferred in



the reorganization and plus any shares of stock received and retained by the Trustees in the reorganization on account of or in exchange for the shares of common stock represented by the certificates; or the trustees may, in their discretion, substitute for such voting trust certificates new voting trust certificates in appropriate form. Whether or not new voting trust certificates are substituted, the term "common stock" as used herein shall include any stock which may be received and retained by the Trustees in a reorganization on account of or in exchange for all or any part of the common stock held hereunder.

9. Voting Rights Of Trustees. The Trustees shall have the right to exercise, in person or by their nominees or proxies, all Stockholders' rights and powers in respect of all common stock deposited hereunder, including the right to vote thereon and to take part in or consent to any corporate or stockholders' action of any kind whatsoever. The Trustees shall have the power and authority to waive any and all rights and privileges which the Stockholders may possess under the Articles of Incorporation or By-Laws of the Company and under the corporation laws of Oregon. The decision or vote of a majority of the Trustees shall constitute the act, decision or vote of the Trustees. The voting trust certificate holders shall not be entitled to receive any notice of stockholders' meetings. The right to vote shall include the right to vote for the election of directors, and in favor of or against any resolution or proposed action of any character whatsoever, which may be presented at any meeting or which may require the consent of common stockholders

of the Company. Without limiting the generality of the foregoing, the Trustees shall have the right to vote for or against the acquisition of any assets by the Company, the mortgaging and pledging of all or any part of the property of the Company, the lease or sale of all or any part of the property of the Company, for cash, credit, securities or other property (or any combination of the foregoing) and for the dissolution of the Company, or the consolidation, merger, reorganization or recapitalization of the Company. In the event of a proposed sale of assets of the Company, consolidation or merger upon which the Stockholders would in the absence of this agreement be entitled to vote and have their shares appraised and paid for if they voted against such sale, consolidation or merger, the Company shall mail to the voting trust certificate holders a plan of the sale, consolidation or merger at least fifteen days prior to the stockholders meeting at which the Trustees will vote upon such sale, consolidation or merger, and any voting trust certificate holder objecting to such plan may file with the secretary of the Company his written objections thereto at least five days prior to the stockholders meeting at which the voting Trustees will vote upon the plan. Any voting trust certificate holder so filing a written objection with the secretary of the Company shall, if the sale, consolidation or merger is adopted, have the right to have the common stock represented by his voting trust certificate appraised and paid for as provided in the corporation laws of the State of Oregon for dissenting stockholders. Except as above provided no voting trust certificate holder shall have any rights as a dissenting Stockholder or otherwise in the event of a sale,



consolidation, merger, recapitalization or reorganization.

10. *Resignation Or Death Of Trustees.* Any Trustee (and any successor trustee) may at any time resign by mailing to the registered holders of voting trust certificates a written resignation to take effect ten days thereafter or upon the prior acceptance thereof. In the event of the death or resignation of any of the Trustees, the successor trustee to fill the vacancy thereby caused, shall be designated and appointed by the remaining Trustee or Trustees. If there is no remaining Trustee, or if the remaining Trustee or Trustees are unable to designate the successor, then the successor trustee shall be designated and appointed by a majority vote of the board of directors of the Company. If the board of directors is unable to designate the successor trustee by a majority vote, then the successor trustee shall be elected by the registered holders of voting trust certificates issued and outstanding under this agreement representing a majority of the number of shares of common stock standing in the name of Trustees hereunder, such election to take place at a meeting of the registered holders of voting trust certificates called upon ten days notice by the remaining Trustee or Trustees, if any, by the Company, or by the registered holders of voting trust certificates representing 25 per cent or more of the number of shares of common stock standing in the name of the Trustees hereunder.

The rights, powers and privileges of the Trustees named hereunder shall be possessed by the successor trustees, with the same effect as though such successors had originally been parties to this agreement.



11. Term Of Agreement And Distribution Of Common Stock Upon Termination. This agreement shall continue in effect for a period of twenty years from the date hereof (subject to extension as hereinafter set forth) but shall terminate at any time upon the execution and acknowledgement by all of the Trustees hereunder of a deed of termination which shall be filed in the office of the Company in Pilot Rock, Umatilla County, Oregon. After common stock has been deposited under this agreement such common stock cannot be withdrawn until this agreement is terminated unless the Trustees in their discretion by written statement release a portion of the common stock held hereunder and such release of a portion of the common stock shall not affect the balance thereof retained hereunder by the Trustees.

Within sixty days after the termination of this agreement the Trustees shall deliver to the registered holders of all voting trust certificates, certificates for the number of shares of common stock represented by the voting trust certificates, upon surrender thereof, properly endorsed. The Trustees may require the persons entitled to receive such certificates to pay a sum sufficient to cover any stamp tax or governmental charge in respect of the transfer or delivery of such certificates. If this agreement is extended as hereinafter provided the Trustees shall continue to hold, subject to all the terms hereof, all the shares of the common stock of the Company represented by the certificates held by the persons becoming parties to the extension agreement.

At any time within one year prior to the time of the termination of this agreement, or at any time within one year prior to the time of expiration hereof as theretofore extended, one or more holders of voting trust certificates hereunder may, by agreement in writing and with the written consent of the Trustees, extend the duration of this agreement for an additional period not exceeding five years. In the event of such extension the Trustees shall file in the office of the Company a copy of such extension agreement and of their consent thereto, provided, however, that no such extension agreement shall affect the rights of voting trust certificate holders not parties to such extension agreement (except assigns of parties to such extension agreement), and holders of voting trust certificates not parties to such extension agreement (except assigns of parties to such extension agreement) shall be entitled to receive the common stock represented by such voting trust certificates free from this voting trust.

12. Compensation and Reimbursement of Trustees. The Trustees shall serve without compensation. The Trustees shall have the right to incur and pay such reasonable expenses and charges, to employ and pay such agents, attorneys, and counsel as they may deem necessary and proper for carrying this agreement into effect. Any such expenses or charges incurred by and due to the Trustees shall be paid by the Company upon demand, and if not so paid may be deducted from the dividends or other moneys or property received by the Trustees on the common stock deposited hereunder. Nothing herein contained shall disqualify any Trustees

or successor trustee from serving the Company (or any of its affiliates) as an officer or director, or in any other capacity, and receiving compensation therefor.

12. Directors' Qualifying Shares. If any Stockholder is now a director of the Company or hereafter becomes a director of the Company, one share of common stock deposited by such Stockholder hereunder shall be issued in his name as a director's qualifying share in compliance with the corporation laws of Oregon, and such Stockholder shall endorse the certificate representing said one share in blank and deposit same with the Trustees and the Trustees shall hold such director's qualifying share hereunder in the same manner and subject to the same terms as the other shares of common stock of such Stockholder held hereunder to the extent permitted by the corporation laws of Oregon.

14. Notice. Any notice to or communication with the holders of the voting trust certificates hereunder shall be deemed to be sufficiently given or made if enclosed in postpaid envelope (regular, not registered mail) addressed to such holders at their respective addresses appearing on the transfer books of the Trustees and deposited in any post office or post office box. Every notice so given shall be effective whether or not received, and the date of mailing shall be the date such notice is deemed given for all purposes.

All distributions of cash, securities or other property hereunder by the Trustees to the holders of voting trust certificates, may be made, in the discretion of



the Trustees by mail (regular or registered mail, as the Trustees may deem advisable) in the same manner as hereinabove provided for the giving of notice to the holders of voting trust certificates.

In Witness Whereof, the parties hereto have caused this agreement to be duly executed on or as of the date first hereinabove written.

OREGON FIBRE PRODUCTS, INC.

/s/ By E. C. KERNS, Pres.

Attest:

/s/ CALVIN N. SOUTHER,  
Secretary.

PILOT ROCK LUMBER CO.

/s/ By E. C. KERNS, Pres.

Attest:

/s/ W. E. THALMAN,  
Secretary.

Trustees:

/s/ A. W. MOLTKE,

/s/ E. C. KERNS,

/s/ CALVIN N. SOUTHER

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[Title of Tax Court and Cause.]

### CERTIFICATE

I, Howard P. Locke, Clerk of the Tax Court of the United States, do hereby certify that the documents submitted under this certificate, 1 to 20, inclusive, as called for by the Designations of Contents of Record on Review, are the original documents of record on file in my office, and a true copy of the docket entries as they appear in the case docketed at the above number, in which the petitioner in this Court has filed a petition for review.

In testimony whereof, I hereunto set my hand and affix the seal of the Tax Court of the United States, at Washington, in the District of Columbia, this 19th day of April, 1961.

[Seal]

HOWARD P. LOCKE,  
Clerk of the Court

/s/ By MAYBELLE W. MUIR  
Deputy Clerk.

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[Endorsed]: No. 17361. United States Court of Appeals for the Ninth Circuit. Standard Lumber Co., Formerly Pilot Rock Lumber Co., Petitioner, v. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Petition to Review a Decision of the Tax Court of the United States.

Filed: April 24, 1961.

Docketed: May 15, 1961.

/s/ FRANK H. SCHMID,  
Clerk of the United States Court of Appeals for the  
Ninth Circuit.

In the United States Court of Appeals  
For the Ninth Circuit

17361

Tax Court Docket No. 77900

STANDARD LUMBER CO., formerly  
PILOT ROCK LUMBER CO.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,  
Respondent.

STATEMENT OF POINTS ON WHICH APPELLANT INTENDS TO RELY ON APPEAL.

Comes now Standard Lumber Co., formerly Pilot Rock Lumber co., Appellant above-named, and for a statement of points on which it intends to rely on this appeal, says:

(1) That the Tax Court erred in finding and holding that appellant was not entitled to file a consolidated return with Oregon Fibre Products, Inc., an Oregon corporation, for the calendar year 1954.

(2) That the Tax Court erred in finding and holding that there are deficiencies in income tax due from appellant for the taxable years 1954 and 1955 in the amounts of \$208,092.16 and \$180,397.47, respectively.

(3) That the Tax Court erred in rendering a decision in favor of the appellee and against the appellant Standard Lumber Co., formerly Pilot Rock Lumber Co.



(4) That the Tax Court erred in failing to enter a decision for appellant and against appellee, Commissioner of Internal Revenue.

Dated this 4th day of May, 1961, at Portland, Oregon.

/s/ WILLIAM H. KINSEY  
Counsel for Appellant  
1001 Board of Trade Building  
Portland 4, Oregon

Affidavit of Service by Mail Attached.

[Endorsed]: Filed May 10, 1961. Frank H. Schmid,  
Clerk.

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No. 17362 ✓

FILED

IN THE

JAN 8 1952

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT FRANK H. SCHMID, CLERK

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FAYE LYONS,

Appellant,

VS

ELSINORE C. MACHRIS GILLILAND, also  
known as ELSINORE MACHRIS GILLILAND,

Appellee.

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Appeal from the United States District Court for the  
Southern District of California,  
Central Division

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APPELLANT'S OPENING BRIEF

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WELBURN MAYOCK

W.S. MAYOCK

524 South Spring Street  
Los Angeles 13, California

Attorneys for Appellant





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1907

THE JOURNAL OF THE  
ROYAL ANTHROPOLOGICAL INSTITUTE

VOLUME XXXVII

PART I

1907

THE JOURNAL OF THE

ROYAL ANTHROPOLOGICAL INSTITUTE

VOLUME XXXVII

PART II

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IN THE  
UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

---

FAYE LYONS,

Appellant,

vs

ELSINORE C. MACHRIS GILLILAND, also  
known as ELSINORE MACHRIS GILLILAND,

Appellee.

---

APPELLANT'S OPENING BRIEF

---

STATEMENT CONCERNING PLEADINGS,  
FACTS AND JURISDICTION

In re: Jurisdiction

This appeal is from a judgment on a retrial of the issues set forth in the second cause of action of plaintiff's Amended Complaint [Tr. p. 6-7] for libel.

"Plaintiff was, at the time of filing the amended complaint herein, a citizen of the State of Florida and the defendant was a citizen of the State of California and the matter in controversy exceeding the sum of \$3,000 exclusive of interest..."

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

FAYE L. FORD,

Appellant,

v.

CLARENCE C. MACGREGOR, also  
known as CLARENCE MACGREGOR, CLARENCE,

Appellee.

APPELLANT'S WRITING SAMPLE

STATEMENT CONCERNING THE WRITING  
SAMPLE AND IDENTIFICATION

In the Subscribed

This appeal is from a judgment on a writ of

of the nature and force in the second case of

action of plaintiff's Assigned Counsel (17) p. 2

7) for libel.

"Plaintiff was, at the time of filing the

assigned counsel herein, a citizen of the State

of Florida and the defendant was a citizen of the

State of California and the matter in controversy

amounting to the sum of \$1,000 exclusive of interest



[Pre-Trial Statement, Exhibit 1 - Rep.Tr. p. 7.]

Where there is diversity of citizenship the District Court has jurisdiction of the case providing the amount in controversy exceeds \$3,000.

28 USCA 1332

The courts of appeal have jurisdiction from all final decisions of the district courts of the United States.

28 USCA 1291

Statement of the Pleadings

The second cause of action of the Amended Complaint is the only cause of action involved herein. Plaintiff alleged: That, on or about the 26th day of November, 1955, at the City of Los Angeles, County of Los Angeles, State of California, the defendant Elsinore C. Machris Gilliland, also known as Elsinore Machris Gilliland, well knowing the premises, in a certain discourse in the presence and hearing of diverse persons, maliciously spoke, wrote and verified and published of and concerning the plaintiff the false and malicious words following, to wit: "That, in May and June, 1955, Ray Gilliland associated with, kept, and did commit adultery with one Faye Lyons, at his

(Pre-trial Statement, Exhibit 1 - Page 1, p. 1.)  
There is no evidence of relationship between  
Gustafson and the jurisdiction of the case pre-  
ceding the amount in controversy exceeds \$5,000.

28 USC 1332

The source of appeal have jurisdiction from  
all final decisions of the district courts of the  
United States.

28 USC 1331

Statement of the Plaintiff

The record shows of action of the defendant  
Complaint is the only cause of action lawfully  
brought. Plaintiff alleges that, on or about the  
15th day of November, 1933, at Los Angeles, California,  
the defendant Eleanor D. Herbert Gillingham, also  
known as Eleanor Herbert Gillingham, well known  
the plaintiff, in a certain document in the name  
and bearing of diverse persons, unlawfully  
procure, make and verified and published of and  
concerning the plaintiff the false and malicious  
words tending, to wit: "That, in May and June,  
1933, Ray Gillingham associated with, kept, and did  
conduct business with one Ray Lyons, at his



residence at 4717 North 71st Place, Scottsdale, Arizona; and that, on the night of September 28, 1955, Ray Gilliland did associate with, keep with him overnight, and did commit adultery with said Faye Lyons at the Colonial House, Las Vegas, Nevada, where Ray Gilliland and said Faye Lyons were registered by him as "Ray Gilliland and Family." That plaintiff herein was never served in said divorce proceeding nor did defendant endeavor to serve said plaintiff nor was plaintiff given an opportunity to defend her good name in the matter nor assuage her feelings by being given the opportunity to defend as required by the Statutes of the State of California. [Tr. p. 6-7]

Defendant admitted the publication of the libel but set up the two defenses of "truth" and "privilege". [Rep.Tr. p. 11, 12, 15, 16, 20]

The jury found that the alleged libel was untrue but that its publication was privileged. [Tr. p. 21]

The judgment for defendant for costs followed. [Tr. p. 22, 23]

#### Statement of the Case

The words used were libelous per se and the



residence at 4717 North Van Ness, San Francisco, California, and that, on the night of September 28, 1935, Ray Gilliland did associate with, have with his overnight, and did commit adultery with said Raye Lyons at the Colonial House, Las Vegas, Nevada, where Ray Gilliland and said Raye Lyons were registered by him as "Ray Gilliland and Family".

That plaintiff herein was never served in said divorce proceeding nor did defendant endeavor to serve said plaintiff nor was plaintiff given an opportunity to defend her good name in the matter nor was she ever failing by being given the opportunity to defend as required by the Statutes of the State of California. (Ex. p. 6-7)

Defendant admitted the publication of the libel but set up the two defenses of "truth" and "privilege". (Ex. p. 8, 9, 10, 11, 12, 13, 14, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24, 25, 26, 27, 28, 29, 30, 31, 32, 33, 34, 35, 36, 37, 38, 39, 40, 41, 42, 43, 44, 45, 46, 47, 48, 49, 50, 51, 52, 53, 54, 55, 56, 57, 58, 59, 60, 61, 62, 63, 64, 65, 66, 67, 68, 69, 70, 71, 72, 73, 74, 75, 76, 77, 78, 79, 80, 81, 82, 83, 84, 85, 86, 87, 88, 89, 90, 91, 92, 93, 94, 95, 96, 97, 98, 99, 100)

The jury found that the alleged libel was untrue but that its publication was privileged. (Ex. p. 111)

The judgment for defendant for costs follows. (Ex. p. 112)

Verdict of the Jury

The jury found that defendant had not and the

publication was admitted. The jury found that they were false.

The jury also found that their publication was privileged.

On the question of privilege, only information which had been communicated to defendant at the time of the publication is relevant.

It is appellant's contention that such evidence in this case is insufficient to support the verdict of privilege and the judgment based thereon.

#### SPECIFICATIONS OF ERROR

Appellant specifies the following errors in the record and proceedings in this case:

##### I

The evidence is not sufficient to support the verdict that the published libel was privileged.

##### II

The evidence was not sufficient to support the "Judgment on Verdict" herein.

#### ARGUMENT

Since the words involved are libelous per se, since their publication is admitted and since

position was similar. The jury found that

they were liable.

The jury also found that their position

was privileged.

On the question of privilege, only informa-

tion which had been communicated in confidence at

the time of the publication is relevant.

It is apparent, a consideration that such in-

formation in this case is irrelevant to support the

verdict of privilege and the judgment based thereon.

## RELEVANCE OF FACTS

Relevant facts are those which are relevant to

the issue and are material to the case.

## I

The relevant facts are those which are relevant to the

issue and are material to the case.

Relevant facts

## II

The relevant facts are those which are relevant to the

issue and are material to the case.

## RELEVANCE

Relevant facts are those which are relevant to the

issue and are material to the case.



they were found to be false the only thing remaining to be discussed is the issue of privilege.

Appellee relied upon the provisions of §47 of the Civil Code of California as a basis for the plea of privilege.

Stripped of words not applicable to this cause that section reads:

"§47 [Privileged publication ...: What constitutes]

"A privileged publication ... is one made -  
... 2. In any ... judicial proceeding ...;  
provided that an allegation or averment contained  
in any pleading ... in an action for divorce,  
made of or concerning a person by or against whom  
no affirmative relief is prayed in such action  
shall not be a privileged communication ... as to  
the person making said allegation or averment with-  
in the meaning of this section unless such plead-  
ing be verified ... and made without malice, by  
one having reasonable and probable cause for  
believing the truth of such allegation ... and un-  
less such allegation be material and relevant to  
the issues in such action ..."

Appellant respectfully contends that the  
burden of proof is on the appellee to bring her-

they were found to be false the only thing possible  
was to be dismissed in the issue of privilege.  
Appellate held upon the provisions of 107 of  
the Civil Code of California as a basis for the  
issue of privilege.

Statement of facts and evidence in this

case was as follows:

The following testimony was given:

Witnesses:

"A witness testified that in the case of

the case of the defendant's wife, the following

provision that an allegation of adultery contained  
in any pleading is an action for divorce,

and it is necessary to prove it in order to  
obtain a divorce which is granted in such cases.

It is also in a privileged communication 114 as to  
the person making such allegations of adultery with

in the hearing of such action unless such person  
has been verified, and some action taken, by

one having knowledge and probable cause for  
believing the truth of such allegation, and an

issue that allegation be material and relevant in  
the case on such action."

Appellate respectfully contends that the  
purpose of such a rule is to give the right to



self within the protection of the above code section (47 CC) and that there is insufficient evidence to show that the allegation was "made without malice, by one having reasonable and probable cause for believing the truth of such allegation".

In re: Malice

Malice may be inferred from words libelous per se.

Davis v. Hearst, 160 Cal. 143-196

To this the following admitted facts should be added.

Appellee did not:

1. Serve appellant as required by §1019 CCP.
2. Seek or secure an order of court for substituted notice as required by §1019 CCP.
3. Attempt to prove the truth of the charge at the divorce trial.

This constituted a serious and illegal invasion of appellant's rights. It leaves as the only logical inference that the naming of appellant was for the purpose of injuring her by publicity with no serious purpose in view of seeking to substantiate the charge.



self within the protection of the laws and  
section 45 (b) and that there is no intention  
to show that the defendant was "guilty"  
without relying on the "guilty" testimony and  
probable cause for holding the truth of such  
testimony.

### In re: [redacted]

[redacted] may be referred to as [redacted]

Page 101

United States v. [redacted], 100 Cal. 113, 114

to this the following admitted facts should

be noted:

[redacted] the [redacted]

1. [redacted] [redacted] as reported by [redacted] [redacted]

2. [redacted] on [redacted] on [redacted] of [redacted] [redacted]

3. [redacted] [redacted] as reported by [redacted] [redacted]

4. [redacted] on [redacted] the [redacted] of the [redacted]

as the [redacted] [redacted]

5. [redacted] a [redacted] and [redacted]

6. [redacted] [redacted] [redacted] [redacted] [redacted] [redacted]

7. [redacted] [redacted] [redacted] [redacted] [redacted] [redacted]

8. [redacted] [redacted] [redacted] [redacted] [redacted] [redacted]

9. [redacted] [redacted] [redacted] [redacted] [redacted] [redacted]

10. [redacted] [redacted] [redacted] [redacted] [redacted] [redacted]

To this additional basis for the inference of malice should be added the considered wisdom of the ages that wives in general regard with hatred, jealousy and even vindictiveness the conjectural concubines of their husbands.

In the face of all this we have only the self serving declaration of appellee herself. "I bear no malice against these people, not any whatsoever".

It is an aphorism of Western Civilization that character is revealed by deeds, not words.

"By their fruits ye shall know them" has until now been considered the summit of wisdom in judging human conduct but this jury in its verdict did its mite to reverse the Sermon on the Mount and bring us a new commandment "Ye shall henceforth judge men by their words and not by their deeds".

In re: Probable Cause

On this subject the burden was on the appellee to show by a fair preponderance of the available evidence that a reasonable person actuated by no malice would be justified from the Blanche Lampert Statement (Exhibit 8) alone in

to this effect, that the influence  
 of justice should be such as to consider whether  
 of the case that arises in general regard with  
 justice, justice and even vindictiveness the con-  
 sideration of justice is essential.

In the case of all this we have only the  
 self-same definition of justice itself.  
 "I have no justice against those people; and my  
 conscience."

It is an assertion of justice civilization  
 that character is founded on justice, and justice  
 "by these things we shall know them" but  
 will not even consider the result of justice  
 in judging human conduct but will not in the case  
 that all this is in justice the justice in the  
 heart and being in a new manner "to what  
 conscience judge and by their words and not by  
 their words."

in the English Case

as was said the justice was in the  
 applied to them in a full consideration of the  
 question whether there is a reasonable person  
 of the case that arises in general regard with  
 justice, justice and even vindictiveness the con-  
 sideration of justice is essential.



believing the truth of the libel.

Only evidence known by appellee at the time of publication can be considered on the issue of privilege.

Davis v. Hearst, 160 Cal. 143-196

The only evidence upon which appellee relied was the Blanche Lampert Statement, Exhibit 8.

In the reporter's transcript the following excerpt is to be found beginning on p. 306, line 7 and ending on p. 308, line 2:

"THE COURT: Received in evidence as Plaintiff's Exhibit next in order.

"THE CLERK: Exhibit No. 8, your Honor.

"THE COURT: In evidence.

(The exhibit referred to was received in evidence and marked as Plaintiff's Exhibit No. 8.)

"MR. MAYOCK: I would like to read it at this time, if your Honor please.

"Statement of Blanche Lampert.

"Saguaro Road, Route 2, Box 621,

"Scottsdale, Arizona, November 2, 1955,

11:00 o'clock a.m.

"Present: --'



"THE COURT: Have you finished with this witness?

"MR. MAYOCK: No, if your Honor please.

"THE COURT: Well, why read this now? Go ahead and finish with the witness.

"MR. MAYOCK: Well, I wanted to read it to her and ask her if that is all she knew about the case, and if it isn't a [p. 306, lines 7-25] fact that that was the source and the complete record of her knowledge, if your Honor please, for filing the complaint. And I don't know any way --

"THE COURT: Can't you ask her that? She has already testified on that. You have asked her and she said, as I recall, what Mrs. Lampert told her and what her lawyer told her and what the neighbors told her.

"MR. MAYOCK: That is very true, if your Honor please. But they have asked the witness these general questions, 'Well, was that substantially what was testified to in court?' and I don't think it is.

"THE COURT: Well, can't you just ask her if what Mrs. Lampert told her is in that statement? The statement is in evidence.



1880

THE COURT - THE NEW YORK AND THE OLD

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THE COURT - THE NEW YORK AND THE OLD

"MR. MAYOCK: Mrs. Gilliland --

"THE COURT: Go ahead and read it then. We are taking more time than it would probably take to read it. Go ahead.

"MR. MAYOCK: Very well. I am going to abide by your Honor's suggestion.

"THE COURT: No. I withdraw the suggestion. Go ahead and read it. We are taking more time now than it would probably take to read it.

"Q BY MR. MAYOCK: Isn't it a fact, Mrs. Gilliland, that you had no information other than the information given you by Blanche Lampert when you accused Faye Lyons and Miss [p. 307, lines 1-26] Meyers of committing adultery with your husband?

"A That's right." [p. 308, lines 1-3]

For convenience, the Blanche Lampert Statement is set forth in full below.

1 "STATEMENT OF BLANCHE LAMPERT

2  
3 Saguaro Road  
4 Route 2, Box 621  
5 Scottsdale, Arizona  
November 2, 1955  
11:00 o'clock a.m.

"THE COURT: In your opinion, is it possible that the

the following facts are true in your opinion?

Can you tell me, Mr. Haydock?

"MR. HAYDOCK: Yes, sir. I can tell you that.

by your Honor's suggestion.

"THE COURT: Mr. Haydock, I wish to ask you a question.

On the 1st of May, 1937, you were talking with the

man whom you saw in the telephone booth on the 1st of

May, 1937, Mr. Haydock, isn't it a fact, that

William, that you had no conversation with

them the information given you by William, that

you saw him on the 1st of May, 1937, and that he

told you that he was a member of the British

your Honor?

"A: Yes, sir, that is what I told you, sir.

the circumstances, the British Empire

is not to be in the hands of the

STATEMENT OF EVIDENCE

1

2

3

4

5

Witnesses:  
James J. Fox (Q)  
Spencer J. Fox (Q)  
James J. Fox (Q)  
James J. Fox (Q)  
James J. Fox (Q)



6 PRESENT: Mrs. Blanche Lampert, Mrs. Elsinore  
7 Machris Gilliland, Mr. William L.  
8 Murphey, and Mrs. Velma Shanks,  
9 court reporter.

EXAMINATION BY

10 MR. MURPHEY:

11 Q Let's start with your name and address.

12 A Blanche Lampert, Scottsdale, Arizona,  
13 Post Office Box 766.

14 Q How long have you worked for Mr. Gilliland?

15 A We were there from the 1st of May  
16 until the last of September.

17 Q Of this year?

18 A Yes, during the summer, we were caretakers  
19 for the place during the summer.

20 Q On any occasion did you ever hear Mr.  
21 Gilliland call Mrs. Gilliland any names?

22 A Yes, I have.

23 Q And on one or more occasions?

24 A Oh, lots of occasions, whenever he would  
25 get drunk and get mad, and he drank terrifically.

26 Q And what did you hear him call her? [p. 1]

1 A Called her 'damned old bitch'. Now, I  
2 don't know how to proceed, shall I start with the  
3 night he blew his stack and was going to shoot



4 everybody?

5 Q About when was it?

6 A It was when you and he came out when the  
7 cooling system was wrong, Mrs. Gilliland, and it  
8 was so hot you were going to stay down there. In  
9 fact, you did, the night I loaned you my night-  
10 gown. It was either May or June, one or the  
11 other.

12 Q About May or June?

13 A Yes.

14 Q All right, go ahead.

15 A Mr. and Mrs. Gilliland came up from Palm  
16 Springs. They came in one car and Fujii came in  
17 the other and she was supposed to stay down there  
18 that night because it was so hot up here. The  
19 air conditioning wasn't working, so he started  
20 feuding with her and fussing with her and being  
21 nasty, so she came on up here anyway.

22 Q That is to the big house?

23 A The big house, so he kept getting drunker  
24 and drunker and drunker and excited, and started  
25 abusing her over the phone.

26 Q What did he call her? [p. 2]

1 A He just told her she hadn't ought to live,





2 and things like that, so then she and Fujii came  
3 back down there and he kept on getting drunker,  
4 so there was about that much whiskey in a bottle  
5 and she poured it through the sink.

6 Q Indicating about an inch?

7 A No, I would say about two drinks, not  
8 more than two drinks left in the bottle. He told  
9 my husband to go get some more and she told my  
10 husband not to, and Ray says, 'Well, you are  
11 working for me, go get it.' My husband got out  
12 and left.

13 He went in the bedroom and he got a gun and  
14 came out and said, 'I am going to kill myself, I  
15 am going to shoot myself,' and she said, 'Go  
16 ahead.'

17 MRS. GILLILAND: I said he would never do it.

18 A He went outside and you says, 'He will  
19 never do it.'

20 He says, 'I will go out and see if this gun  
21 works,' and he shot the thing off outside.

22 So when I said to you, I said, 'Ought we go  
23 look for him?' You said, 'Oh, no, he will never  
24 do it,' so he came back in. He says, 'I am going  
25 to shoot you,' and he started that way with that  
26 gun. He said, 'You damned old bitch you, you [p.3]

1 now almost like that, it then rose and fell again  
2 and then came back and he began to get up, saying,  
3 so there was about the same way in a way, he  
4 and the ground in the middle of the  
5 O. The ground about the middle  
6 a lot, I would say about the middle, and  
7 now there was about the same way in the middle, he said  
8 up, looking in the way and he was told by  
9 himself and he was very sure, 'well, you are  
10 waiting for me, he said, 'he looked at the  
11 and said,  
12 he was the first to see him and he was told  
13 came out and said, 'I was waiting for him, he said,  
14 he was the first to see him, and he said, 'he  
15 was the first to see him,  
16 he was the first to see him, he said, 'he  
17 was the first to see him, he said, 'he  
18 was the first to see him, he said, 'he  
19 was the first to see him, he said, 'he  
20 was the first to see him, he said, 'he  
21 was the first to see him, he said, 'he  
22 was the first to see him, he said, 'he  
23 was the first to see him, he said, 'he  
24 was the first to see him, he said, 'he  
25 was the first to see him, he said, 'he



1 ought to die,' and I crawled under the table, I  
2 was scared, the way he was swinging that gun  
3 around like that, and he did threaten to shoot  
4 her.

5 Q All right, any other occasions - was that  
6 the only incident of the gun that you observed?

7 A Yes, of the gun, yes.

8 MRS. GILLILAND: But I never said one word,  
9 I never answered him, I never said an unkind word  
10 to him.

11 A You never done nothing, no.

12 MR. MURPHEY: Q Did you ever hear Mrs.  
13 Gilliland say anything abusive to Mr. Gilliland?

14 A Oh, no.

15 Q Was she always nice to him?

16 A Yes, nicer than I would be if he talked  
17 to me the way he talked to you.

18 Q All right. Now, how many occasions would  
19 you estimate you heard Mr. Gilliland call Mrs.  
20 Gilliland a 'bitch' or 'God damned bitch' or  
21 anything similar to that?

22 A Just about every time he talked to her,  
23 and after he talked to her he would call other  
24 people and they would discuss what all they were  
25 going to do. He would do that at the rate of

1 I want to tell you a story about the world.  
2 One day, the sun was shining very bright  
3 and the birds were singing. The children were  
4 playing in the park.  
5 One day, the sun was shining very bright  
6 and the birds were singing. The children were  
7 playing in the park.  
8 One day, the sun was shining very bright  
9 and the birds were singing. The children were  
10 playing in the park.  
11 One day, the sun was shining very bright  
12 and the birds were singing. The children were  
13 playing in the park.  
14 One day, the sun was shining very bright  
15 and the birds were singing. The children were  
16 playing in the park.  
17 One day, the sun was shining very bright  
18 and the birds were singing. The children were  
19 playing in the park.  
20 One day, the sun was shining very bright  
21 and the birds were singing. The children were  
22 playing in the park.  
23 One day, the sun was shining very bright  
24 and the birds were singing. The children were  
25 playing in the park.

26 about every other day. [p. 4]

1 He would call her up on the telephone and  
2 call her a bitch and then he would call Judge  
3 Williams.

4 Q Judge Williams?

5 A Judge Williams, and they would talk over  
6 the situation and try to figure out some way they  
7 was going to clip her. I don't know what Judge  
8 Williams said, I knew Ray's conversation.

9 Q What did he say in substance?

10 A Well, he just said he was going to get  
11 her behind the eight ball where she belonged and  
12 really clip her, and he would say he was going to  
13 get a Mexican divorce, and then he would say,  
14 'That old bitch ought to die.'

15 Q What did he call her, 'that old bitch'?

16 A Yes, always that.

17 Q 'That old bitch ought to die'?

18 A Yes, and something else, he always said,  
19 he told everybody, he made it very plain to every-  
20 one after they were married he never had anything  
21 to do with her, never intended to have anything to  
22 do with her. He said, 'How could anyone expect  
23 a guy like him to have anything to do with an old



1 The court will hear on the testimony and  
2 will hear a brief and then the court will judge  
3 William.  
4 Q Judge Williams?  
5 A Judge Williams, and then will talk over  
6 the situation and say to himself and the jury that  
7 was going to say that I don't know what Judge  
8 Williams said. I know Ray's conversation.  
9 Q What did he say in substance?  
10 A Well, he said he was going to say  
11 that he didn't know what the defendant said  
12 and he said that he would say he was going to  
13 say a certain amount, and then he would say  
14 that he would say to the jury.  
15 Q And he said he would say to the jury?  
16 A Yes, he said that.  
17 Q That's all right, isn't it?  
18 A Yes, and everything else he always said,  
19 he told everybody, he said it was plain to every  
20 one that he was not going to say anything  
21 and he said that he was not going to say anything  
22 to the jury, and he said that he would say to the jury  
23 that he was not going to say anything to the jury.

24 woman like that.' He said he never would con-  
25 summate the marriage.

26 Q Now, any other incidents that you particu-  
[p. 5]

1 larly remember along that line of abuse?

2 A Well, it was just those same things all  
3 the time, all the time he would call his daughter,  
4 he would call Patty Karger, and he would always  
5 want someone around to hear what was said or  
6 have somebody listen in on that other telephone  
7 in there.

8 Lots of times when he talked to her he would  
9 have one of these girl friends down there, or  
10 Patty Karger, whoever was there, would be listen-  
11 ing in on the extension phone to see what was going  
12 on.

13 Q How often would Mr. Gilliland have guests  
14 at his home when Mrs. Gilliland was around, were  
15 they ever there alone that you know of?

16 A Oh, sure, he had Faye Lyons from Miami  
17 and -- I think he was a little scared to be alone,  
18 he acted like it, always going to have somebody  
19 come if there wasn't nobody there, has had lots  
20 of guests there.

74 woman said that, "he said he never would con-  
75 siderate the marriage."

76 Q Now, any other incidents that you recollect  
77 {p. 21}

78 Early morning along that line at about

79 A Well, it was just about seven o'clock all

80 the time, all the time he would call his daughter

81 he would call Betty, Margie, and he would always

82 come around around to that time was said to

83 have somebody later in on that other telephone

84 in there.

85 One of those men he called he had he would

86 have one of those girl friends there, or

87 Betty Margie, whoever was there, would be there.

88 and in on the telephone phone to see what was

89 any

90 Q How often would Mr. Gilliam have guests

91 at his home then Mr. Gilliam was away, would

92 they ever think about that you know not

93 A Oh, sure; in fact they have been there

94 and -- I think he was a little nervous at the time

95 he stood him in, always going to have somebody

96 come to their house, nobody there, and had some

97 of guests there.



21 Q What have you observed as to women being  
22 there?

23 A Well, Faye Lyons.

24 Q And when was that approximately?

25 A Well, let's see - in May when we first  
26 went there, I will tell you how I know it was before  
[p. 6]

1 we went on our vacation and Faye was there, he  
2 was keeping her at that time up at Paradise  
3 Valley, because I cooked a steak dinner for them,  
4 Paradise Valley Guest Ranch.

5 Q Just tell us what you observed.

6 A He got mad at Judge Blake and Phil Kent  
7 and all of them, and he went and stayed all night  
8 up there himself.

9 Q Up where?

10 A At paradise Valley, when Faye was there.  
11 She used to come down and stay until two and  
12 three o'clock in the morning. They used to sit  
13 in there and drink together and we was in our  
14 own bedroom out there, they were in there until  
15 two or three o'clock in the morning, then they  
16 went on a trip and came back.

17 Q Who went on a trip?



18 A Mr. Gilliland and Faye, I don't know  
19 where they went, but anyway when they came back  
20 they brought Faye's boy back with them and it  
21 didn't work, and they got in a fight and Ray  
22 slapped her and she throwed a glass at him, Faye  
23 broke a glass on him.

24 Q After they came back with the boy did she  
25 live there at the house that you know of?

26 A No, she took the boy up to Paradise Valley,  
[p. 7]

1 only she was down there every day and I baby sat  
2 with the boy, or one of the neighbors did.

3 Q Until what hour of the morning?

4 A Until two or three o'clock.

5 Q Was <sup>BL</sup>she intoxicated?

6 A Sure.

7 Q--<sup>BL</sup>Both-of-them?

8 A--<sup>BL</sup>Sure.

9 Q Any other instances?

10 A Yes, then --

11 Q Now, before we get away from here, what  
12 period of time would you say approximately that  
13 this woman was involved?

14 A Oh, from May until I would say June, she



1. The following are the names of the persons

2. who have been appointed to the various positions

3. in the various departments of the Government

4. and the names of the persons who have been

5. appointed to the various positions in the

6. various departments of the Government

7. and the names of the persons who have been

8. appointed to the various positions in the

9. various departments of the Government

10. and the names of the persons who have been

11. appointed to the various positions in the

12. various departments of the Government

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14. appointed to the various positions in the

15. various departments of the Government

16. and the names of the persons who have been

17. appointed to the various positions in the

18. various departments of the Government

19. and the names of the persons who have been

20. appointed to the various positions in the

21. various departments of the Government

22. and the names of the persons who have been

23. appointed to the various positions in the

24. various departments of the Government

15 was here most of the summer. Then when she left,  
16 why, he had Ann Myers, but Ann stayed right there  
17 in the house.

18 Q All the time?

19 A Yes, only time she didn't stay there was  
20 one time Ann and his sister and Pat Karger, he  
21 moved them all up to Paradise Valley Guest Ranch.

22 Q Moved who?

23 A His sister and Patty Karger and Ann Myers,  
24 but otherwise Ann Myers, I think she was there  
25 about three weeks altogether.

26 Q And what time of the year was that? [p. 8]

1 A Well, it was along about July or August  
2 while we was still there.

3 Then they got into a big fight and he cussed  
4 her out one night, and she called me the next day  
5 from Vegas and wanted to know if he was still  
6 drinking and I told her no, he had quit that day.

7 He left the next morning and went up to  
8 Vegas to meet her up there. I don't know what  
9 happened, he didn't get there as soon as he  
10 should and she called again, but he told me he  
11 turned his car over on the way up there was why  
12 he was delayed, I don't know.

14 was very much of the same kind. When with the 1052,  
15 107, the 1052 and 1072, but the 1072 is the 1072  
16 in the 1072.  
17  
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40

1 A. Well, it was about 10:15 on August  
2 10:15 he was still there.  
3 Then they got back a big light and he came  
4 out out out night, and the 1072 on the same day  
5 from 10:15 and came to him 10:15 he was still  
6 10:15 and I told him he had got that day,  
7 he had the 1072 coming and went up to  
8 10:15 he was out of there, I don't know what  
9 happened, he didn't get there as soon as he  
10 should and the 1072 again, but he was in  
11 10:15 he was out of there as soon as he  
12 he was out of there, I don't know.



13 He was so drunk all the time all this was  
14 going on, the girls would fuss and feud with him  
15 because <sup>BL was BL</sup> ~~they~~ were so drunk all the time.

16 Judge Blake knows about this Faye Lyons.  
17 When Blakes' was staying there, they stayed there  
18 three or four days, and when they were there Mr.  
19 Blake would go up to Paradise Valley and get Faye  
20 and bring her down and Ray would take her back.

21 Q Now, were there any other women that you  
22 observed him keeping at the house?

23 A No, them two, unless you would consider  
24 Patty Karger.

25 Q How many times did Patty Karger come down  
26 there?

A She was there three or four times, she  
[p. 9]

1 always had this Cohen, and Ray told me one time,  
2 'You know she doesn't care nothing about him, he's  
3 just a friend.' I don't know.

4 Q Did they occupy separate bedrooms?

5 A Yes.

6 Q Peggy Myers, too?

7 A You can't tell too much about that, we  
8 had our bedroom over there, what was going on -- I

1 The first of these is the fact that the

2 second of these is the fact that the

3 third of these is the fact that the

4 fourth of these is the fact that the

5 fifth of these is the fact that the

6 sixth of these is the fact that the

7 seventh of these is the fact that the

8 eighth of these is the fact that the

9 ninth of these is the fact that the

10 tenth of these is the fact that the

11 eleventh of these is the fact that the

12 twelfth of these is the fact that the

13 thirteenth of these is the fact that the

14 fourteenth of these is the fact that the

15 fifteenth of these is the fact that the

16 sixteenth of these is the fact that the

17 seventeenth of these is the fact that the

18 eighteenth of these is the fact that the

19 nineteenth of these is the fact that the

20 twentieth of these is the fact that the

21 twenty-first of these is the fact that the

22 twenty-second of these is the fact that the

23 twenty-third of these is the fact that the

24 twenty-fourth of these is the fact that the

25 twenty-fifth of these is the fact that the

26 twenty-sixth of these is the fact that the

9 could tell as a housekeeper, and I have seen him  
10 in her room with shorts on and her in nothing but  
11 a slip.

12 Q Which one was that?

13 A Mrs. Myers. One morning Ann Myers answered  
14 the phone, Ray was in there that morning with his  
15 shorts on and her with a slip.

16 Q During all of the time that Mrs. Gilliland  
17 was there did you ever hear her say anything  
18 derogatory or abusive to him?

19 A No, I never did.

20 Q Did you ever see him throw anything in  
21 the house?

22 A Oh, he threw glasses all over the house,  
23 yes, ice and glasses he would at her.

24 Q Did you ever see Mrs. Gilliland throw  
25 anything at him?

26 A No, the only thing I ever saw her do was  
pour about that much whiskey out, around two  
[p. 10]

1 drinks.

2 Q What was his reaction to the whiskey  
3 incident?

4 A That is when he was going to shoot his





5 self, that is when he got his gun.

6 Q Well, is there anything else you think  
7 might be of assistance?

8 A That is all I know, I am just telling the  
9 truth, that is all I am doing, because you know  
10 if I would ever get to court to testify, if you  
11 tell the truth then you will never get tangled up,  
12 and attorneys have a way of tangling people up if  
13 they don't tell the truth.

14 I do know that he bought an automobile.

15 Q How do you know that he bought an automo-  
16 bile?

17 A I saw the title.

18 Q All right, then you tell us about it.

19 A He bought the automobile, and he bought  
20 it on down payment, he didn't pay for it, I saw  
21 the title and I saw what payments were and anyway  
22 Faye Lyons had it and he got mad at her and took  
23 it away from her.

24 Q Was she driving it?

25 A Sure, she drove it all the time, she said  
26 she was going to Vegas. When they had the fuss I  
[p. 11]

1 kept the little boy the night before. I said





2 'Are you still going to Vegas?' She said, 'No, I  
3 am going to Miami, he took the car away from me  
4 so now I am going back home.'

5 Q What kind of car was it?

6 A Dodge. I think he bought it from Ed  
7 Spears.

8 I know that he had been wanting all the time  
9 he was always wanting to go into such big things,  
10 and always when he would get back he would call  
11 Judge Williams, he would call his daughter, he  
12 would call Andy Anderson, he would call everybody  
13 and then he would just stand there and just rave.

14 He called Phil Barnett and wanted Phil to  
15 file for divorce right away and Phil said no.

16 Q You couldn't hear very well, could you?

17 A Sure, I was on the extension telephone,  
18 he always have somebody listening in.

19 Q He had you on there?

20 A Yes, I was on the extension phone and Phil  
21 says, 'You know if you do, you are going to have  
22 to say your health is ruined.' He wanted alimony  
23 or separate - for a while to get that money, and  
24 Phil said, 'You know she's in the hospital right  
25 now,' and he said, 'You'd better wait and see how  
26 she's coming out of that.' [p. 12]



1 Q When was that?

2 A Oh, it was July or August, along maybe  
3 first of August, I would say, when Phil come back  
4 from his trip, and he said that Phil said, 'You  
5 might profit by waiting.' He says, 'You know,  
6 Ray, I don't want to file for divorce because,'  
7 he says, 'You know what you are going to have to  
8 testify to if you do, but if you really want me  
9 to I will.'

10 Q Did they say anything about the grounds?

11 A Well, his health was ruined, that was the  
12 main thing.

13 Q Mental cruelty?

14 A Liquor is what ruined his health.

15 Q Has he ever made any statements to you  
16 not to disclose any information?

17 A Yes, he did.

18 Q What did he say along that line?

19 A He said never to tell anything. Not only  
20 that, 'Well,' he says, 'You just stay by me,' and  
21 he says, 'I will buy something and I will give  
22 you a job,' and which I wasn't looking for a job,  
23 and he says, 'I will get plenty and I will make it  
24 all right with you.' Well, I din't know -- I  
25 told him, I said, 'You don't owe me anything.'





26 But there is one thing I want you to know  
this to begin with, when we left there we left as  
[p. 13]

1 friends, there was no argument, no fuss or feuding  
2 or anything.

3 Q Were you fired?

4 A Well, we only had the agreement when we  
5 went there to stay until the 1st of September  
6 and we stayed until the last.

7 Q And then you left?

8 A Well, we didn't have no fuss or argument  
9 is what I am saying.

10 Q You have no malice toward him?

11 A No, the only malice is him talking so mean  
12 to her, that is all the malice I have.

13 This all took place at 4717 North 71st Place,  
14 Mr. Gilliland's address, in that house, not in  
15 this house.

16 Ann Myers has traveled all over the coast  
17 with Mr. Gilliland, I believe it was the first part  
18 of August, she had some parcels mailed home from  
19 San Francisco, and they visited Andy Anderson in  
20 Fresno. He left her sitting in a hotel and she  
21 got mad about it.





22 He told me Mrs. Gilliland had already given  
23 him over \$500,000.00, he said he was going to  
24 clip her for five million. When he got the five  
25 million he would take care of all of us.

26 MR. MURPHEY: Well, I think that is about it.

[p. 14]

1 She will type it up and bring it to you. Read  
2 it over carefully before you sign it and make any  
3 corrections you want to make.

4

5 - - - - -

6

7

8 STATE OF ARIZONA )  
9 County of Maricopa ) SS

10       BLANCHE LAMPERT, being first duly sworn,  
11   upon her oath deposes and says that she has read  
12   the foregoing statement and knows the contents  
13   thereof and that the same is true to her knowledge.

14

15 Blanche Lampert  
BLANCHE LAMPERT

16

17 Subscribed and sworn to before me this 5th  
18 day of November, 1955, by Blanche Lampert.



19

20

Velma Shanks  
Notary Public

21

22 My commission expires  
23 May 19, 1956."

It will be noted that the Statement consists of 15 pages of 26 lines each.

Reference to appellant therein is as follows:

Page 6, line 13 to page 8, line 15 = 55 lines

Page 11, line 19 to page 12, line 4 = 12 lines

Nowhere is the subject of adultery mentioned.

The charge of adultery is a serious thing, particularly against a woman. Accusations which could ruin a reputation and even lives should not be spoken rashly on the basis of mere anger or of groundless surmise.

That the charge of adultery against appellant was false has already been judicially established by the verdict herein. We are only concerned with whether appellee acted reasonably and without malice when she made the charge.

When this case was previously before this court the same issue was before the court. In that decision the court said "The ultimate basis





for the order granting the new trial, then, would be the lack of sufficient evidence to establish good faith and lack of malice as required by Statute." Gilliland v. Lyons, 278 F.2d 56

The same situation meets us here and the same ruling by the same court is respectfully urged.

Proof of adultery can be made in two ways:

(1) by direct evidence; (2) by indirect evidence.

No direct evidence was communicated to appellee by the Blanche Lampert Statement or by any other evidence.

Proof by indirect evidence is made by proof of opportunity plus proof of the propensity of the parties to commit adultery.

This means propensity of both parties.

Propensity by one only will not suffice.

Davis v. Hearst, 160 Cal. 143-196

116 Pac. 530

Koenigstein v. Koenigstein, 53 Cal.

App. 673, 200 Pac. 730

Hartshorn v. Hartshorn, (Okla.),

67 Ok. 45, 168 Pac. 822

State v. Eggleston, (Ore.), 45 Ore.

346, 77 Pac. 738-42

Wilson v. Wilson, 124 Cal.App. 655,





The record is silent on the point of propensity on the part of the appellant. Her categorical denial of adultery is the only competent and relevant evidence in the record.

Thus there is a complete failure of proof of adultery by indirect evidence. No legal inference of adultery can therefore be drawn. The drawing of baseless and illogical inference is not reasonable and cannot satisfy the requirements of "reasonable and probable cause" imposed by the privilege statute (*supra*).

Upon the identical "lack of evidence" found by this court in this cause on the first appeal appellant asks the same ruling in this appeal.

Since the issue of truth has been disposed of and since there is not sufficient evidence to support the plea of privilege as a matter of law, the only issue for a re-trial would be the issue of damages.

The procedure of restricting issues, in a proper case, is well established by law.

The second is found on the basis of the  
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 the fact that the only evidence in the case is  
 the fact that the only evidence in the case is

There is a single fact in the case of  
 which the fact is not in the case, the fact  
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 of which the fact is not in the case, the fact

Upon the second "fact of evidence" found by  
 the court in this case on the fact of evidence  
 found by the court in this case on the fact of evidence

There is a fact of evidence found by the court  
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The fact of evidence found by the court  
 is a fact of evidence found by the court

Donnatin v. Union Hardware & Metal,

38 Cal.App. 8 (at 12); 175 Pac. 26

In a proper case, such as this, restricting the issues saves the court and the parties from re-trying issues already tried and avoids burdens of time and expense to all concerned.

### CONCLUSION

Since, as shown, appellee has failed to establish the basis set out in the Statute of Privilege as a matter of law, a reversal of the verdict and judgment is respectfully urged and it is further urged that in remanding the cause for a new trial the issue be restricted to the issue of damages alone.

Respectfully submitted,

WELBURN MAYOCK

W.S. MAYOCK

By WELBURN MAYOCK

Attorneys for Appellant



Memorandum of Understanding

10 Cal. App. 2d 112 (1954)

In a recent case, with the following facts, the court held that the contract was enforceable and the parties were bound by its terms. The court also held that the contract was enforceable and the parties were bound by its terms. The court also held that the contract was enforceable and the parties were bound by its terms.

DISCUSSION

It is well known that the contract was enforceable and the parties were bound by its terms. The court also held that the contract was enforceable and the parties were bound by its terms. The court also held that the contract was enforceable and the parties were bound by its terms. The court also held that the contract was enforceable and the parties were bound by its terms.

Respectfully submitted,

WILLIAM HAYES  
J. HAYES

BY WILLIAM HAYES

Attorney for Appellant

No. 17362

IN THE

# United States Court of Appeals

FOR THE NINTH CIRCUIT

---

FAYE LYONS,

*Appellant,*

*vs.*

ELSINORE MACHRIS GILLILAND, also known as ELSI-  
NORE MACHRIS GILLILAND,

*Appellee.*

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## APPELLEE'S BRIEF.

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LARWILL & WOLFE,

453 South Spring Street—1024,  
Los Angeles 13, California,

*Attorneys for Appellee.*

FILED

FEB 2 1962

FRANK H. SCHMID, CLERK





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## APPELLEE'S BRIEF.

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### Statement of the Pleadings and Facts.

Appellant, as plaintiff, brought an action against the Appellee, as defendant. Her complaint contained several causes of action in each of which she prayed for damages from the Appellee, in excess of \$3,000.00, exclusive of interest. In the first trial of the action, a final judgment was rendered against the Appellant and for the Appellee on all of the causes of action pleaded in the complaint except one, the second cause of action. Although a judgment for Appellee had been entered on the second cause of action, the trial court granted a new trial thereof.

The second cause of action pleaded an alleged libel of Appellant by Appellee, assertedly arising out of a publication in a cross-complaint for divorce, filed by the Appellee against her husband, in the Superior Court



of the State of California, in and for the County of Riverside. In said cross-complaint Appellee's husband was charged with having committed adultery with Appellant.

In the second trial of the said second cause of action, —a trial by Jury—a verdict was returned against the Appellant and in favor of Appellee, and a judgment was entered thereon. From said judgment the Appellant has taken this appeal.

### Statement of the Case on Appeal.

The issue on this appeal is: Was there, in the jury trial, evidence introduced by which, believing the same, the jury could find (as they did) that Appellee's defense of privilege had been sustained thereby.

The Appellee had pleaded in her answer to Appellant's complaint, among other things, that she was entitled to the privilege provided by Section 47 of the California Civil Code, relating to judicial proceedings for divorce. The jury's verdict was for the Appellee, upon her defense of said privilege.

The only two specifications of error which Appellant asserts and upon which she relies are: that there was insufficient evidence to justify the Jury's findings (1) that Appellee acted without malice and (2) that Appellee had reasonable and probable cause for believing the truth of the said allegations.

In Appellant's Opening Brief, she has cited evidence, which serves to refute her claims that there was insufficient evidence. The evidence so cited is, in fact, more than ample to sustain the findings and the verdict of the Jury, and the judgment entered thereon. Appel-

lant states that the only evidence concerning lack of malice is the testimony of Appellee [Rep. Tr. p. 298, line 7, to p. 299, line 21] that she had no ill will or malice towards Appellant when she made the allegations in her divorce cross-complaint. Who would know better? Yet Appellant asks the court to cast aside and ignore the testimony of Appellee, who was a witness in the Court trial subject to examination and cross-examination, and in lieu thereof, casually to infer that malice most likely existed.

Appellant's attempts to support her argument that Appellee did not have reasonable cause to believe the truth of the alleged libelous publication, by the statement of the witness, Blanche Lampert. Appellant asserts that the only knowledge of Appellee upon which she based her allegations was received by Appellee from the witness Blanche Lampert, at the time the latter made the statement hereinafter set forth.

Blanche Lampert stated that Appellant went to Scottsdale, Arizona, from Miami, Florida, at the solicitation of Appellee's husband; that upon and after Appellant's arrival in Scottsdale, she and Appellee's husband, Ray Gilliland, associated together at the latter's home, during a period of several months; that they remained together in said home almost every night, and drank together and became intoxicated at late hours, almost every night; that they took trips together and stayed all night together in the Paradise Valley Guest Ranch.

From the foregoing substantial and damaging evidence alone, a Jury could hardly do otherwise than find that Appellee had reasonable and probable cause for believing the truth of her allegation, and made them with-

out malice, at the time she pleaded in her cross-complaint that her husband had committed adultery with Appellant.

The evidence above summarized is substantial, clear and (as the Jury found) convincing. The only evidence at the trial, relating to the question of malice, was that Appellee acted without malice. There was no evidence that Appellee acted with malice.

The evidence of the association and conduct of Appellant and the husband of Appellee certainly cannot be said, by any stretch of the imagination, to provide reasonable and probable cause for believing otherwise than as Appellee believed.

The Jury performed its functions in the manner provided by law; it was fully instructed as to its duties and in the law, by the trial Judge; it considered and weighed all the evidence in the case, and then returned a verdict against the Appellant and in favor of the Appellee. Insofar as the decisions upon the evidence relating to the facts in the case are concerned, Appellant has had her day in court.

Appellant herself, by citing the foregoing evidence is now estopped from arguing further that there is no evidence in the case sufficient to support the Jury's verdict.



## ARGUMENT.

### Appellant's Brief Establishes a Record Which Fully Supports the Verdict and Judgment.

Appellant declines to accept and deal with the basic principles and rules of law which apply here and which constitute an insurmountable barrier to any further prosecution of her claims against Appellee. These principles are, that the decisions to be made upon the facts are the sole responsibility of the Jury, evidence is adduced, as it was, in abundance, both on behalf of the plaintiff and on behalf of the defendant, and the same is received in evidence, the determination of the effect of such evidence, in establishing the true facts as to whether or not the plaintiff has proved her claim and as to whether or not the defendant has made proof of her defense thereto, rests solely with the Jury.

In the matter of this appeal the basic question is whether or not there was evidence adduced at the trial from and upon which the members of the Jury could determine (as they did) that the Appellee, in making the allegations in her divorce cross-complaint did so without malice toward the Appellant and had reasonable and probable cause for believing the truth of the allegations. The record is replete with evidence directed to these issues. They were, perforce, the vital question upon the determination of which the case must be decided, the verdict returned and the judgment entered.

By the very nature of the case, the crucial evidence was that which related to the association of the Appellant with Ray Gilliland, the Appellee's husband, and their conduct when together.

The evidence (which will be cited hereinbelow in more detail) established an association and continuing conduct which were definitely unconventional. The evidence of what they did, when together, established continuing conduct which is generally considered to be contrary to, and in violation of accepted social conventions, customs and standards of behavior. In addition to the many unconventional situations in their association actually observed and concerning which testimony was introduced in evidence, there were many other items of evidence statements relative to the frequent opportunities available to them for their being alone, and of times when they were known to have been together entirely by themselves.

The testimony regarding their association and conduct included a protracted motor trip which provided stops for night lodgings along the way [Rep. Tr. p. 218, lines 1-3; p. 75, lines 5-11; p. 77, lines 10-19; p. 80, lines 8-20; p. 89, lines 7-19; p. 91, line 8, to p. 93, line 11]. Testimony as to their conduct in the presence and observation of other people disclosed drinking bouts, arguments, quarreling and fighting with one another and even slapping each other when one or both of them had been drinking. All of these things constitute the indicia and circumstances commonly associated with misconduct. They certainly are not the indicia of rectitude and virtue.

From these established facts of Appellant's and Gilliland's association and their conduct, which affair was



one of a series of affairs Appellee's husband had carried on at his Scottsdale home and the neighboring guest ranch [see Rep. Tr. p. 223, line 29, to p. 225, line 23] the Jury, after due deliberation, found that Appellee, as a reasonable person, acting without malice, had sufficient cause and reason to believe the truth of the allegation made by her in her cross-complaint for divorce. For Appellee, under these circumstances, to have believed otherwise would have indicated an unusual and unlikely naiveté.

Appellant's association and conduct with Appellee's husband, by reason of their marriage, were matters of direct and vital concern to Appellee. She was no mere casual busybody or scandalmonger. As Gilliland's wife she was directly and personally involved. The association affected her existing marriage relationship. The nature and character of her husband's relations with Appellant were such that most wives would believe their husbands were guilty of misconduct that amply provided a wife with legal grounds for divorce.

Appellant was not a child. She was an adult, and a twice previously married woman [Rep. Tr. p. 52, lines 7-8, and p. 53, lines 9-10]. The situation with which Appellee was so vitally concerned, was created entirely by Appellant's own conduct in associating herself with Gilliland. Appellee, quite naturally, was concerned with Gilliland and with his conduct. Appellant deliberately associated herself with Gilliland, in an intimate and prolonged relationship. The Appellee had no personal acquaintance or concern with the Appellant. It was by Appellant's own choice and her own conduct that she made herself the "other woman" in the divorce case. This is no proof of "malice" on the part of Appellee.



Yet Appellant, in her brief, asks that "malice" be inferred and that the undisputed testimony of Appellee, that she made her allegations in her divorce cross-complaint, without any personal acquaintance with, or ill will or malice toward the Appellant herein, now be disregarded and ignored. It may not be disregarded or ignored because of the fact and the record herein that the Jury has resolved and determined the question of malice and has found against Appellant's contentions.

This determination of the facts having been made by the Jury, in the exercise of its exclusive function of determining facts, and upon due deliberation and consideration of the entire record of the case (which included all of the above matters presented herein) and a verdict having been rendered thereon, the said verdict becomes a final and conclusive determination of all issues and conflicts of facts and must be considered fully qualified for acceptance by both trial and any reviewing courts.

### **Answer to Appellant's Argument Relating to "Propensity."**

Appellant's opening brief states that: "The record is silent on the point of propensity on the part of Appellant." (App. Op. Br. p. 9).

The issue of propensity is irrelevant. Upon this appeal there is no issue or question of adultery involved. As stated heretofore, the only issue upon this appeal is,—was there evidence to establish the Appellee's defense of "privilege"?

In spite of its irrelevance Appellant has chosen to argue the evidence of "propensity". The statement

that the record is silent on this matter of propensity, however, is a completely incorrect statement.

The facts are these: That all of the evidence pertaining to Appellant's association with Ray Gilliland, contained proof relevant to her propensity for the conduct involved.

For example, such testimony as: she admitted that she stayed overnight in a hotel with Ray Gilliland in rooms that had connecting doors [Rep. Tr. p. 75, lines 5-11 and p. 79, lines 8-16]; she testified, "that it didn't make any difference \* \* \* whether the rooms in the motels and hotels," that she, and Mr. Gilliland occupied had interconnecting doors or not [Rep. Tr. p. 120, lines 11-17]; that she took an automobile trip with Gilliland from Scottsdale, Arizona to Miami, Florida, of from seven to ten days, and they stayed overnight in the same hotels and motels along the way, the names of most of which she could not remember [Rep. Tr. p. 75, lines 5-11; p. 77, lines 10-19; p. 80, lines 8-20; p. 84, lines 7-19; and p. 91, line 8, to p. 93, line 11].

Appellant testified she did not know how they registered at the Fort Worth Hilton Hotel [Rep. Tr. p. 83, lines 5-10].

There was evidence that Appellant permitted Gilliland to stay all night with her in her room at the Paradise Valley Guest Ranch [Rep. Tr. p. 221, line 3, to p. 222, line 6].

There was evidence that she accepted money from Gilliland [Rep. Tr. p. 227, line 13, to p. 228, line 20]; also an airplane ticket [Rep. Tr. p. 102, lines 16-18].

This evidence and additional evidence of similar conduct set forth herein, in more detail, goes directly to the establishment of the “propensity” on the part of Appellant, concerning which she argues: “the record is silent. . . .”

### Summary of the Evidence Relevant to This Appeal, and the Law Applicable Thereto.

The well established law is that it is the trier of the facts, (in this case the Jury) who has the sole responsibility and duty of determining and deciding conflicts of evidence. Where, as here, a verdict of a Jury is attacked on the ground of insufficiency of the evidence, the sole duty of the reviewing Court is only to examine the record and see if there is substantial evidence, contradicted or not, which supports the Jury's verdict. The reviewing Court is not charged with the duty of weighing the strength or persuasiveness of conflicting evidence. The reviewing Court's duty begins and ends with the determination of whether there is substantial evidence in the record, which if believed, supports the verdict.

In *People v. Hickie*, 179 Cal. App. 2d 823, 827-828 (1960), the court said:

“It is, of course, for the trier of fact to determine the weight to be given to the opinion of an expert witness . . .; it is the exclusive judge of the effect and value of the evidence . . . and the credibility of witnesses . . . , lay and expert . . .; and it has the primary function of resolving factual conflicts . . .

“Where findings are attacked on the ground of insufficiency of the evidence, the power of the re-



viewing court begins and ends with the determination of whether there exists in the record substantial evidence, contradicted or not, which will support the same . . . and if there is, the strength of opposing evidence or inferences is immaterial, for evidence is not weighed on appeal . . .

“Likewise, we are bound to liberally construe the findings in support of the judgment indulging in all reasonable inferences, resolving every substantial conflict in the testimony and construing any uncertainties in their favor.”

The foregoing doctrines are so firmly established that they have become legal maxims.

*Peterson v. Exum* (1960-9th Cir.), 283 F. 2d 499, 502;

*Primm v. Primm* (1956), 46 Cal. 2d 690, 693;

*Grainger v. Antoyan* (1957), 48 Cal. 2d 805, 807;

*Brewer v. Simpson* (1960), 53 Cal. 2d 567, 583;

*Miller v. Hassén*, (1960), 182 Cal. App. 2d 370, 376.

At pages 10 to 26 inclusive of Appellant's Opening Brief there is set forth the "Statement of Blanche Lampert" plaintiff's Exhibit 8 [Rep. Tr. p. 306, lines 11-12]. Appellant asserts that said statement contains the only information known to Appellee concerning the association of Appellant and Ray Gilliland, husband of Appellee, and was the information upon which Appellee relied when she filed her divorce cross-complaint, which contained language alleged by Appellant to be libelous. This was not the only information upon which appellee relied although appellee was well aware of all

of these facts, as well as of additional facts concerning Appellant's conduct with Appellee's husband. However, these facts set forth by Appellant in her Opening Brief are, in and by themselves, so convincing that when they were presented to the Jury, these facts completely refuted Appellant's argument to the Jury that the evidence was not sufficient to establish the fact that Appellee had reasonable and probable cause for believing the truth of her said allegations. The pertinent excerpts from the "Statement of Blanche Lampert" made on November 2, 1955, are as follows:

"Q. How long have you worked for Mr. Gilliland? A. We were there from the 1st of May until the last of September.

Q. Of this year? A. Yes, . . .

Q. How often would Mr. Gilliland have guests at his home when Mrs. Gilliland was around, were they ever there alone that you know of? A. Oh, sure, he had Faye Lyons from Miami . . ."

(Appellant's Op. Br. p. 16.)

"Q. What have you observed as to women being there? A. Well, Faye Lyons.

Q. And when was that approximately? A. Well, let's see—in May when we first went there, I will tell you how I know it was before we went on our vacation and Faye was there, he was keeping her at that time up at Paradise Valley, because I cooked a steak dinner for them, Paradise Valley Guest Ranch.

Q. Just tell us what you observed. A. He got mad at Judge Blake and Phil Kent and all of them, and he went and stayed all night up there himself.

Q. Up where? A. At Paradise Valley, when Faye was there. She used to come down and stay until two and three o'clock in the morning. They used to sit in there and drink together and we was in our own bedroom out there, they were in there until two or three o'clock in the morning, then they went on a trip and came back.

Q. Who went on a trip? A. Mr. Gilliland and Faye, I don't know where they went, but anyway when they came back they brought Faye's boy back with them and it didn't work, and they got in a fight and Ray slapped her and she throwed a glass at him, Faye broke a glass on him.

Q. After they came back with the boy did she live there at the house that you know of? A. No, she took the boy up to Paradise Valley, only she was down there every day and I baby sat with the boy, or one of the neighbors did.

Q. Until what hour of the morning? A. Until two or three o'clock.

BL

Q. Was she intoxicated? A. Sure.

BL

Q. ~~Both of them?~~ A. Sure.

Q. Any other instances? A. Yes, then—

Q. Now, before we get away from here, what period of time would you say approximately that this woman was involved? A. Oh, from May until I would say June, she was here most of the summer. . . ." (Appellant's Op. Br. pp. 17, 18, 19.)

The Appellant, by reason of her acts of associating with Appellee's husband, being kept by Gilliland at the motel, staying all night with him, drinking with him



every night, fighting with him when drinking, and going alone on a trip with him, in the Jury's opinion, gave Appellee reasonable and probable cause for believing the truth of the allegations Appellee made in her divorce cross-complaint.

At the trial of the action Mrs. Lampert corroborated her statement above cited. She testified that the Paradise Valley Guest Ranch was a form of a motel near Gilliland's home [Rep. Tr. p. 217, lines 11 to 18]; that the trip that Appellant and Gilliland took together was from Scottsdale, Arizona to Miami, Florida [Rep. Tr. p. 218, lines 1-3]; that Gilliland and Appellant were alone at Gilliland's home almost every night until 2 or 3 o'clock in the morning and that she saw them drinking together [Rep. Tr. p. 220, lines 11-13]; that Gilliland stayed with Appellant all night at the Paradise Valley Guest Ranch [Rep. Tr. p. 221, line 3, to p. 222, line 6]; that she saw him come out of Faye Lyons' room about 8 o'clock the next morning [Rep. Tr. p. 222, lines 1-6]; that Appellant had a fight with Gilliland and threw a glass at him [Rep. Tr. p. 222, line 7, to p. 223, line 20]; that Gilliland boasted of his affairs with women and said that he wouldn't have them around if he "couldn't do anything" . . . he "wanted with them" [Rep. Tr. p. 225, line 18]; that Gilliland had affairs with other women (which showed Gilliland's propensities to the adultery charge) [Rep. Tr. p. 229, line 12, to p. 233, line 20]; that the witness saw Gilliland kissing Faye Lyons two or three times [Rep. Tr. p. 234, lines 4-6]. She also testified that she told Mr. Murphey, Appellee's attorney, about the girls who stayed with Gilliland and what they did and all of the other facts she related as a witness [Rep. Tr. p. 235, lines 4-7].

Mr. William L. Murphey, a lawyer representing Appellee, Mrs. Gilliland, talked to the witness Blanche Lampert in 1955 and at that time the witness, Blanche Lampert, told Mr. Murphey in substance what she testified to at the trial [Rep. Tr. p. 268, line 16, to p. 269, line 25]. Mr. Murphey related all of these facts to Appellee [Rep. Tr. p. 271, line 25, to p. 272, line 11]; and he told Appellee his opinion of the inference that could be drawn from these acts of Gilliland. He advised his client that in his opinion said acts of Gilliland and Appellant were of such gravity as to constitute sufficient grounds upon which to charge adultery [Rep. Tr. p. 275, line 17, to p. 277, line 6].

Appellee, Mrs. Gilliland, testified that her information concerning the conduct of her husband with Appellant came from the witness Blanche Lampert and from her attorney, Mr. Murphey and her Scottsdale neighbors [Rep. Tr. p. 299, line 22, to p. 300, line 11].

The evidence of the witnesses as to the affair between Appellant Faye Lyons and Appellee's husband, Ray Gilliland, was corroborated in most parts by the Appellant herself. She testified that Gilliland took her to the Paradise Valley Ranch House which was a little farther than three or four hundred feet from Gilliland's home [Rep. Tr. p. 70, lines 4-20]; that she knew that she should not be alone with Gilliland [Rep. Tr. p. 72, lines 6-10]; that if she did so she would be subjecting herself to something very unsavory [Rep. Tr. p. 72, lines 3-7]. The Appellant further admitted that the trip she took with Gilliland, testified to by the witness Blanche Lampert, was a ten day automobile trip from Scottsdale, Arizona to Miami, Florida, during which time she was alone with Gilliland and stayed at



many hotels and motels with him [Rep. Tr. p. 75, lines 5-11; p. 77, lines 10-19; p. 80, lines 8-20; p. 84, lines 7-19; p. 91, line 8, to p. 93, line 11].

In spite of all of this evidence which was presented to the Jury during the trial, Appellant on page 29 of her Opening Brief, states that "there is not sufficient evidence to support the plea of privilege as a matter of law . . . ."

The Jury disagreed with Appellant. It considered the evidence sufficient to establish privilege on the part of Appellee. The jury believed that the facts were such as to give Appellee reasonable and probable cause for believing the truth of the allegations she made.

After all of the evidence was adduced at the trial, it became the right and duty of the Jury to decide whether the accusations made by Appellee were privileged. In *Larrick v. Gilloon*, 176 Cal. App. 2d 408, 418 (1959)—a libel action—the court instructed the Jury as to the meaning of probable cause, as follows:

"Probable cause means that the defendant was in possession of facts which would have led a reasonable person so situated to entertain an honest belief maintained in good faith that the statements made were true. Whether the defendant was thus actuated by actual malice and whether he had probable cause to believe and did in good faith believe the defamatory statement to be true are questions of fact for the jury."

The above stated rule of law was applied to the facts in this case, by the Jury, after receiving instructions thereon from the trial Court. As was its right and duty, the Jury duly considered and weighed all of the facts



hereinabove set forth. From and upon said facts the Jury determined that Appellee had reasonable and probable cause to believe the truth of the allegations of misconduct made in her cross-complaint for divorce.

The Appellant does not deny the facts—she admits them. Her only complaint is that the Jury gave too much weight to these facts. This, however, does not constitute a proper ground for appeal because the Jury is the sole judge of the weight of the evidence.

The law relating to verdicts of a jury in federal court actions is accurately and concisely set forth in *Peterson v. Exum* (1960, 9th Cir.). 283 F. 2d 499, 502, as follows:

“It must be borne in mind that in actions at law under federal diversity jurisdiction the Seventh Amendment guarantees a right to trial by jury. Preservation of that right requires that questions of fact be left to the jury and that findings of fact by a jury be left undisturbed unless reasonable men must conclude that there is insubstantial evidence in their support.”

### Conclusion.

Appellee has established by clear and substantial evidence, to the satisfaction of the Jury and the Trial Court, that the allegations contained in her divorce cross-complaint were a privileged publication. The verdict of the Jury and the judgment thereon in her favor were proper in every respect. Appellant's argument is untenable, particularly in the light of all of the facts in the case, including her own admitted conduct. Since many of the facts relied upon by the Jury were pointed out by the Appellant herself, the Appellant is

estopped from complaining of the Jury's determination of the weight given to these facts.

Appellant herein has failed to comply with the requirements and to meet the test of the firmly established rule, stated in *Miller v. Hassen* (1960), 182 Cal. App. 2d 370, 376, that

“The contention that findings lack evidentiary support ‘requires defendants to demonstrate that there is no substantial evidence to support the challenged findings.’”

We submit that upon the record, and for the reasons presented herein, the appeal should be denied.

Respectfully submitted,

LARWILL & WOLFE,

*Attorneys for Appellee.*

No. 17362

IN THE  
UNITED STATES COURT OF APPEALS  
FOR THE NINTH CIRCUIT

---

FAYE LYONS,

Appellant,

vs

ELSINORE C. MACHRIS GILLILAND, also  
known as ELSINORE MACHRIS GILLILAND,

Appellee.

---

Appeal from the United States District Court for the  
Southern District of California,  
Central Division

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APPELLANT'S REPLY BRIEF

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WELBURN MAYOCK  
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Attorneys for Appellant

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IN THE  
UNITED STATES COURT OF APPEALS  
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FAYE LYONS,

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Appellee.

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Appeal from the United States District Court for the  
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APPELLANT'S REPLY BRIEF

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STATEMENT OF THE PLEADINGS AND FACTS

Appellant will not repeat her Statement of the Pleadings and Facts as set forth on pages 2 to 4, inclusive, of her Opening Brief. Respondent conceals an important part of the verdict by words which connote a general verdict for the Appellee was returned (Appellee's Brief, p. 2, lines 5-10, incl.).

The "verdict" itself is to be found on page 21 of the Transcript of Record.



It shows that two defenses had been urged:

(a) Truth, (b) Privilege. The verdict was for the Appellant and against the Appellee on the defense of "Truth". The verdict was for the Appellee and against the Appellant on the issue of "Privilege". The appropriate Judgment in favor of Appellee for costs followed (Tr. p. 22-23) wherein the recital that the defense of "truth" had not been established was repeated.

#### STATEMENT OF THE CASE ON APPEAL

In Appellee's Statement of the Case on Appeal (p. 4, lines 8-12, incl.) Appellee states "The evidence of the association and conduct of Appellant and the husband of Appellee certainly cannot be said, by any stretch of the imagination, to provide reasonable and probable cause for believing otherwise than as Appellee believed".

Appellee completely ignores the law that it was only information which she knew at the time of the libel which can be considered in the defense of "privilege". Davis v. Hearst, 160 Cal. 143-196.

Appellee searches the evidence at the trial on both issues of Truth and Privilege to find substantial evidence to sustain the verdict on the issue of





Privilege. Such evidence is not available on the issue of Privilege. Appellee is restricted to evidence she knew at the time of the libel which she has testified was restricted to the Blanche Lampert Statement (Rep. Tr. p.306, line 7 to P. 308, line 2, incl.).

Appellee's rhetorical assertion about adultery, being in effect the only inference which could be drawn from the evidence "by any stretch of the imagination", finds massive refutation in the "verdict" which found that inference untrue, in the granting of a new trial on the first trial because of the insufficiency of the Blanche Lampert Statement plus "what her husband had told her prior to their marriage" and "what her attorney had told her" and also in the opinion of this Honorable Court in the first Appeal (Gilliland v. Lyons, 278 F.2d 56).

Until Appellee first heard the Lampert Statement (Exhibit No. 8) she had never heard of Appellant. This follows from her own testimony, Rep. Transcript p. 17, lines 1-5:

"Q. By Mr. Mayock: Did you direct your attorney to make any effort to serve Fay Lyons with your Cross-complaint in this action?" (Divorce action).





"A. I didn't even know Fay Lyons. I never even heard of her name."

Again on Rep. Transcript (p. 25, line 8 to 23, incl.) the following appears:

"Q. By Mr. Mayock: Mrs. Gilliland, the Blanche Lampert statement that was made in Arizona was dated November the 2nd in 1955. I say this for the purpose of refreshing your recollection. Had you talked with Blanche Lampert before that?

"A. I have never talked to Blanche Lampert. I have never spoken to a single soul in my life about the case.

"The Court: Whose housekeeper was Blanche Lampert?

"The Witness: She was Mr. Gilliland's housekeeper. I had never spoken to her. The only time we heard from her was when Mr. Murphy came down and took the affidavit. That was the only time I ever heard about these women.

"Q. By Mr. Mayock: But you had spoken to Blanche Lampert?

"A. I beg your pardon. We have never talked about women."



Appellant will not labor this point any further. Appellee has completely overlooked or completely ignored the ruling in Davis v. Hearst, supra, to the effect that in the defense of Privilege only knowledge of what the libelant knew at the time of the libel can be considered. At least the Brief of Appellee fails to consider or refer to this point.

### ARGUMENT

In that portion of Appellee's Brief denoted Argument on p. 5, the basic fallacy of Appellee stands starkly revealed. Appellee asserts that on the defense of Privilege which is the only matter we are concerned with in this appeal "the basic question is whether or not there was evidence adduced at the trial from which the members of the Jury could determine (as they did) that Appellee, in making the allegations in her divorce complaint did so without malice toward Appellant and had reasonable and probable cause for believing the truth of the allegations".

Here is fundamental error. Not at the trial years later, but when she published the libel did she have sufficient knowledge to meet the test of probable cause? Not what Appellee with skillful counsel backed by a millionaire could with money and





detectives assemble for the trial in the way of evidence, but what she knew when she chose to libel the Appellant alone is available to her on the issue of Privilege.

She has testified that this consisted of the Blanche Lampert Statement alone. To this, vague assertions of "what her husband told her" may be added. At the time of the libel he had told her nothing about any women, but on the contrary, had denied any misconduct with women. (R.Tr. 170, lines 6-13)

What her husband told her, according to her alone, many months after the libel is not available evidence on the defense of Privilege.

What neighbors told her did not concern Appellant, but referred to unidentified women having been seen in Mr. Gilliland's yard.

What Appellee's attorney told Appellee was that months before Appellant came to California he saw a strange woman's face in Mr. Gilliland's house when he peeked through a window and that later when he accused Mr. Gilliland of having a woman in his house he replied "What of it?".

In evidence available on the defense of Privilege only the Blanche Lampert Statement mentions Appellant and it asserts that Appellant did not go to Las Vegas.





On this information only plus a stipulation that Appellant was in Florida at the time she was accused of adultery in Las Vegas, Nevada, Appellee bases her unsubstantiated defense of Privilege as to the Las Vegas adultery.

Both the learned District Judge on the granting of the New Trial and this Honorable Court on the Appeal from the order granting the New Trial have pointed out the insufficiency of this restricted evidence to meet the obligation of Appellee, under the Statute on the element of probable cause.

The record is equally silent on the libel of adultery in Arizona. Appellee states that the record shows that.

#### In re: Propensity

Appellant completely disagrees with Appellee on the matter of propensity. Appellee says it is irrelevant (App. Brief. p. 8, line 25). Appellant respectfully contends that since "probable cause" is the basis of the defense of Privilege, proof of "probable cause" to believe adultery must be shown by Appellee. The evidence upon which Appellee relied must be such as to lead a reasonable person to believe adultery had occurred. This evidence must be direct



or indirect. There was no direct evidence available to Appellant at the time of the libel.

Therefore, her "probable cause", if any, must be found in "indirect evidence". This must be found in the Blanche Lampert Statement. "Propensity of both parties" is an indispensable element in the inference of adultery by indirect evidence. It is equally an indispensable element in the inference of adultery inherent in probable cause to draw the inference of adultery.

### CONCLUSION

Appellee has failed to consider or evaluate three principles of law which in the opinion of Appellant are determinative of this appeal.

(1) What evidence is available to a libelant on the defense of "Privilege"?

(a) Appellant says "only evidence of which libelant was aware at the publication of the libel" and cites Davis v. Hearst, supra.

(b) Appellee says "all evidence introduced at the trial" and bases her position on assertion only, citing no precedents.

(2) Can the inference of adultery based upon indirect evidence be proved without proof of





"propensity" of both parties to commit the adultery?

(a) Appellee says "yes" it can be proved by proof of propensity of one only of the alleged adulterers and bases her conclusion on assertion only, citing no precedents.

(b) Appellant says "no" it can be proved only by proof of propensity of both parties and cites ample precedents (pp. 28 and 29 of her Opening Brief).

(3) Can proof of "probable cause" by indirect evidence be established without proof of propensity of both parties?

(a) Appellee says "yes" and cites neither precedent nor argument on the matter.

(b) Appellant says "no", and argues that since indirect evidence of adultery must depend on proof of propensity of both parties before a reasonable inference can be drawn it follows that "probable cause" must also require the same essential element for the purpose of drawing a reasonable inference of adultery on that issue.

To hold otherwise is to hold that probable cause can be "unreasonably" or illogically inferred.

Appellant therefore respectfully urges a reversal of the Judgment and verdict and again urges that





in remanding the cause for a new trial the issue be restricted to the issue of damages alone.

Respectfully submitted,

WELBURN MAYOCK  
W.S. MAYOCK

By WELBURN MAYOCK

Attorneys for Appellant



No. 17362

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United States  
Court of Appeals  
for the Ninth Circuit

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FAYE LYONS,

Appellant,

vs.

ELSINORE C. MACHRIS GILLILAND, also known  
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Appellee.

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Transcript of Record

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Appeal from the United States District Court for the  
Southern District of California,  
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FILED

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No. 17362

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**United States  
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FAYE LYONS,

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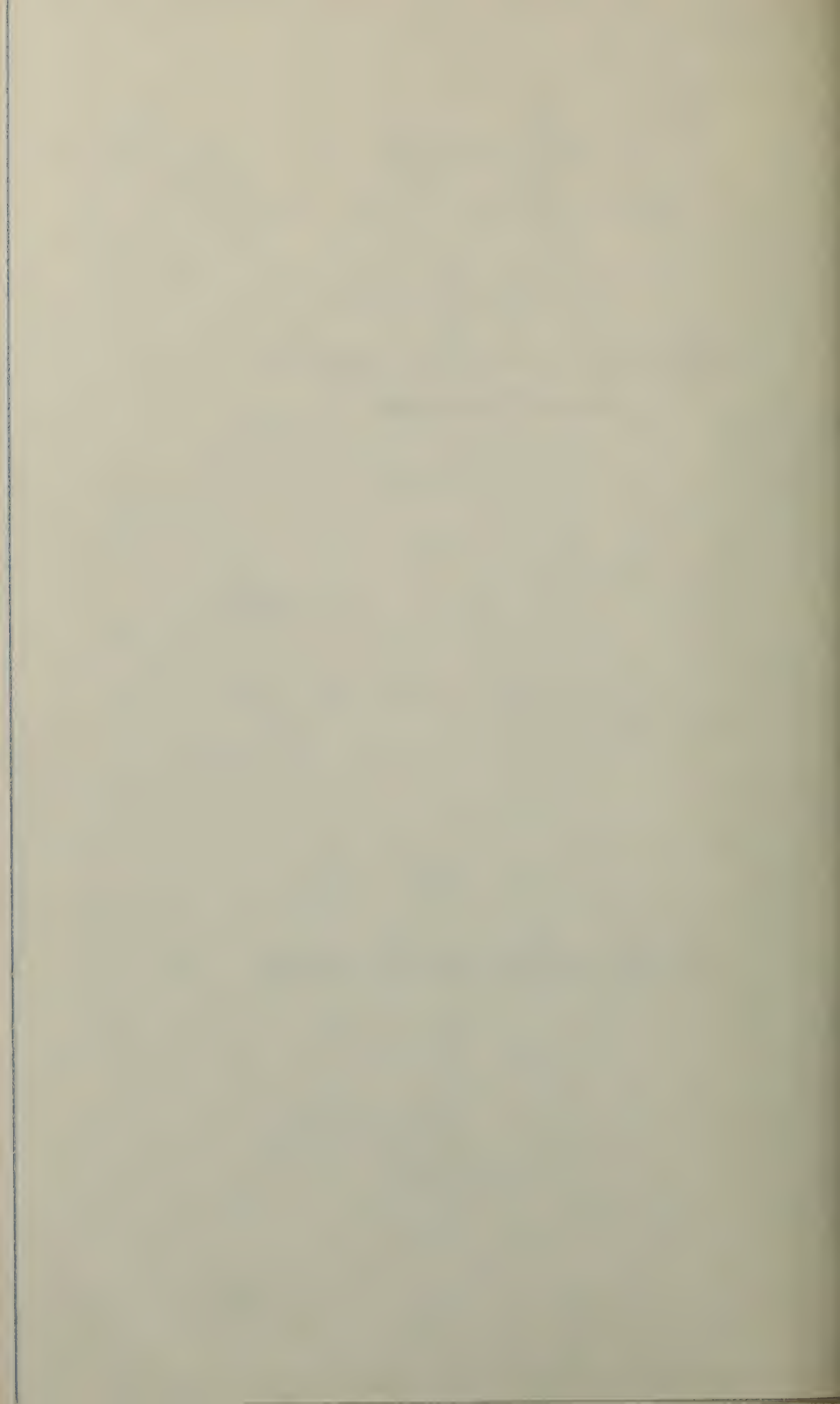
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**Transcript of Record**

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Appeal from the United States District Court for the  
Southern District of California,  
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in *italic*; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in *italic* the two words between which the omission seems to occur.]

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## NAMES AND ADDRESSES OF ATTORNEYS

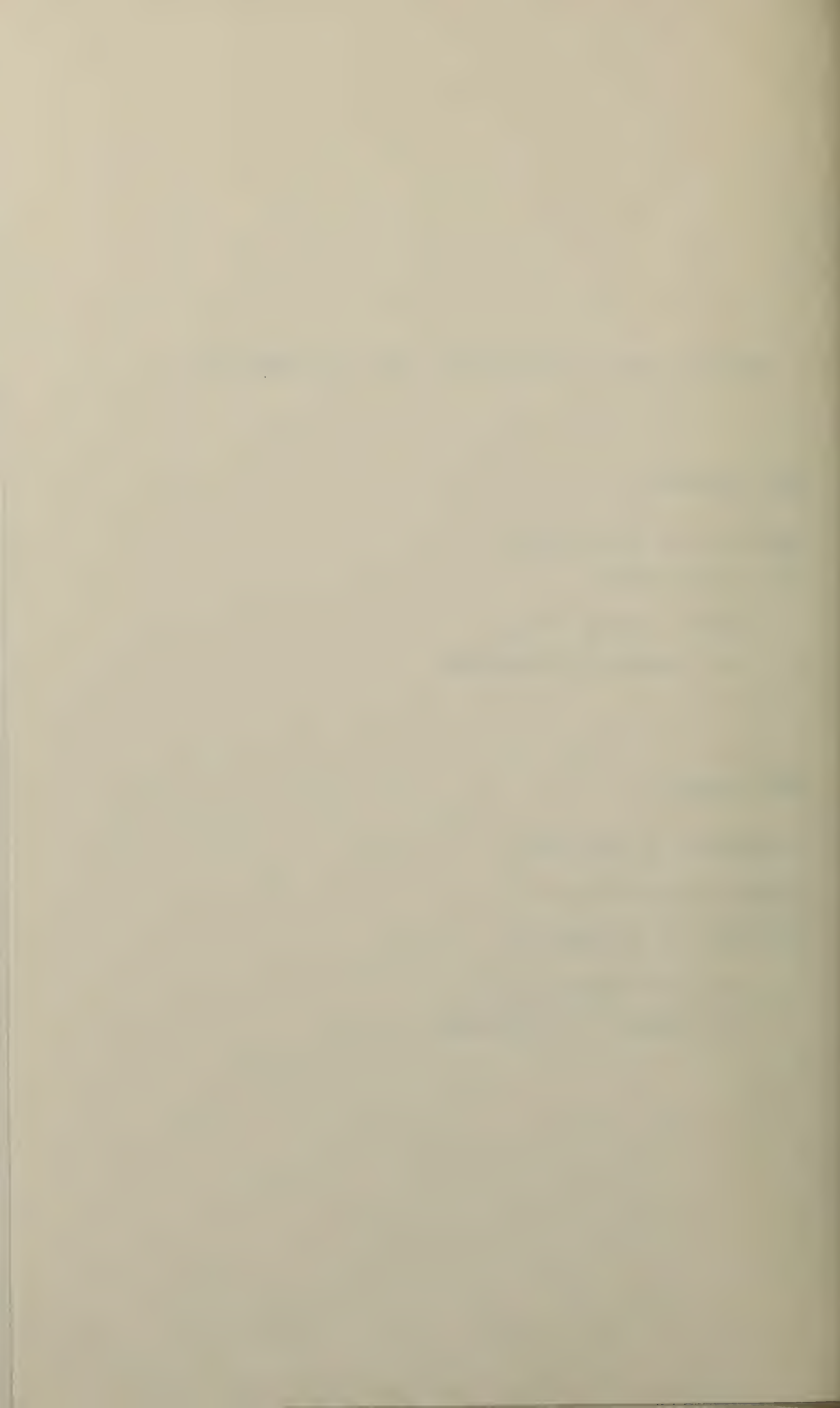
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United States District Court,  
Southern District of California,  
Central Division

No. 20301 PH

FAYE LYONS,

Plaintiff,

vs.

ELSINORE C. MACHRIS GILLILAND, also known  
as ELSINORE MACHRIS GILLILAND,

Defendant.

### AMENDED COMPLAINT

(Libel—Invasion of Privacy—Slander)

Comes Now the plaintiff and for her cause of action  
alleges the following:

#### I

Jurisdiction exists in the above entitled Court by reason that plaintiff is a citizen of the State of Florida, County of Dade, and defendant is a citizen of the State of California, County of Riverside. The matter in controversy exceeds, exclusive of interest and costs, the sum of Three Thousand Dollars (\$3,000.00).

#### II

That the defendant, on or about the 29th day of March, 1955, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff the false and malicious words following, to wit: "Ray is shacking up with Faye Lyons." That the defend-

ant, on or about the 10th day of August, 1955, at Palm Springs, California, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff the false and malicious words following, to wit: "Ray is shacking up with Faye Lyons." That the defendant, on or about the 26th day of November, 1955, at Los Angeles, California, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff and false and malicious words following, to wit: "That, in May and June, 1955, Ray Gilliland associated with, kept, and did commit adultery with one Faye Lyons, at his residence at 4717 North 71st Place, Scottsdale, Arizona; and that, on the night of September 28, 1955, Ray Gilliland did associate with, keep with him overnight, and did commit adultery with said Faye Lyons at the Colonial House, Las Vegas, Nevada, where Ray Gilliland and said Faye Lyons were registered by him as "Ray Gilliland and Family." That the defendant, on or about the 21st day of December, 1955, at Riverside, California, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff the false and malicious words following to wit: "Ray is being punished for sleeping with Faye Lyons." That the defendant, on or about the 14th day of February, 1956, at Scottsdale, Arizona, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff the false and malicious words following, to wit: "Ray shacked up with Faye Lyons."



That the defendant, on or about the 15th day of May, 1956, at Scottsdale, Arizona, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff the false and malicious words, following to wit: "Ray shackled up with Faye Lyons." That the defendant, on or about the 26th day of March, 1956, at Phoenix, Arizona, in a certain discourse which the defendant had in the presence and hearing of diverse persons, maliciously spoke and published of the plaintiff the false and malicious words following, to wit: "Ray shackled up with Faye Lyons."

### III

That the defendant meant by the foregoing false and malicious words that the plaintiff was unchaste; that she lived in concubinage and was guilty of a felony under, and by virtue of, the laws of the State of Arizona by reason that the plaintiff had been guilty of the crime of adultery.

### IV

That by means of the published of said false and malicious words, the plaintiff has been caused great mental pain, distress, humiliation, and mortification, and has been exposed to public contempt, ridicule, aversion and disgrace and has caused an evil opinion of her in the minds of her acquaintances and the public generally, the plaintiff is greatly injured in her name and reputation and has been rendered liable to prosecution for adultery, all to her damage in the sum of Five Hundred Thousand Dollars (\$500,000.00).

## V

That in doing the things herein alleged, the defendant acted maliciously, was guilty of a wanton disregard of the rights and feelings of plaintiff, and by reason thereof, plaintiff demands exemplary and punitive damage against the said defendant in the sum of Five Hundred Thousand Dollars (\$500,000.00).

## For a Second Cause of Action

Comes Now the plaintiff and complains and alleges as follows for her second cause of action herein.

## I

Incorporates herein by reference as completely as though set forth herein in full, Paragraphs I, II, III, IV and V of her first cause of action herein.

## II

That, on or about the 26th day of November, 1955, at the City of Los Angeles, County of Los Angeles, State of California, the defendant Elsinore C. Machris Gilliland, also known as Elsinore Marchris Gilliland, well knowing the premises, in a certain discourse in the presence and hearing of diverse persons, maliciously spoke, wrote and verified and published of and concerning the plaintiff the false and malicious words following, to wit: "That, in May and June, 1955, Ray Gilliland associated with, kept, and did commit adultery with one Faye Lyons, at his residence at 4717 North 71st Place, Scottsdale, Arizona; and that, on the night of September 28, 1955, Ray Gilliland did associate with, keep with him overnight, and did commit adultery with said Faye Lyons at the Colonial House, Las Vegas, Nevada, where Ray Gilliland and said Faye Lyons were regis-

tered by him as "Ray Gilliland and Family." That plaintiff herein was never served in said divorce proceeding nor did defendant endeavor to serve said plaintiff nor was plaintiff given an opportunity to defend her good name in the matter nor assuage her feelings by being given the opportunity to defend as required by the Statutes of the State of California.

### III

That the defendant meant by the foregoing false and malicious words that the plaintiff was unchaste; that she lived in concubinage and was guilty of a felony under, and by virtue of, the laws of the State of Arizona by reason that the plaintiff had been guilty of the crime of adultery.

### IV

That by means of the publishing of said false and malicious words, the plaintiff has been caused great mental pain, distress, humiliation, and mortification, and has been exposed to public contempt, ridicule, aversion and disgrace and has caused an evil opinion of her in the minds of her acquaintances and the public generally, the plaintiff is greatly injured in her name and reputation and has been rendered liable to prosecution for adultery, all to her damage in the sum of Five Hundred Thousand Dollars (\$500,000.00).

### V

That in doing the things herein alleged, the defendant acted maliciously, was guilty of a wanton disregard of the rights and feelings of plaintiff, and by reason thereof, plaintiff demands exemplary and punitive damage against the said defendant in the sum of Five Hundred Thousand Dollars (\$500,000.00).



## For a Third Cause of Action

Comes Now the plaintiff and complains and alleges as follows for her third cause of action herein.

## I

Incorporates herein by reference as completely as though set forth herein in full, Paragraph I, II, III, IV and V of her first cause of action and Paragraphs I, II, III, IV and V of her second cause of action.

## II

That defendant, Elsinore C. Machris Gilliland, sought newspaper publicity, gave interviews to the press, endeavored to have her story written in the magazine known as Confidential for, as she often said, "Her public must be informed." That by reason of her endeavors, there was published in a newspaper of general circulation on or about March 23, 1956, as well as spoken and plead by the defendant, the following, to wit:

"In her counter complaint for divorce, Mrs. Gilliland accuses her husband of having affairs with two socially prominent women at Lake Tahoe and other affairs in May, June and July of 1955 with two other women at his residence at 4717 N. 71st Pl., Scottsdale, Arizona, a suburb of Phoenix.

Named as co-respondents in the counter complaint were "Ann (Peggy) Meyers" and "Faye Lyons."

In an affidavit, Mrs. Gilliland stated she had an annual income of \$267,000 in 1954 and requires at least \$10,000 a month subsistence."

That the defendant meant by the foregoing false and malicious words that the plaintiff was unchaste; that she lived in concubinage and was guilty of a felony

under, and by virtue of, the laws of the State of Arizona by reason that the plaintiff had been guilty of the crime of adultery.

IV

That by means of the publishing of said false and malicious words, the plaintiff has been caused great mental pain, distress, humiliation, and mortification, and has been exposed to public contempt, ridicule, aversion and disgrace and has caused an evil opinion of her in the minds of her acquaintances and the public generally, the plaintiff is greatly injured in her name and reputation and has been rendered liable to prosecution for adultery, all to her damage in the sum of Five Hundred Thousand Dollars (\$500,000.00).

V

That in doing the things herein alleged, the defendant acted maliciously, was guilty of a wanton disregard of the rights and feelings of plaintiff, and by reason thereof, plaintiff demands exemplary and punitive damage against the said defendant in the sum of Five Hundred Thousand Dollars (\$500,000.00).

Wherefore, plaintiff prays judgment against the defendant for the sum of Five Hundred Thousand Dollars (\$500,000.00), as compensatory damage, and for the sum of Five Hundred Thousand Dollars (\$500,000.00) as exemplary and punitive damages, for costs of suit, and for such other and further relief as to the Court may deem just and equitable in the premises.

/s/ COIT I. HUGHES,

Attorney for Plaintiff.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed Nov. 20, 1956.

[Title of District Court and Cause.]

## ANSWER TO AMENDED COMPLAINT

For answer to plaintiff's Amended Complaint, defendant admits, denies, and alleges as follows:

### As to the First Cause of Action

#### I

For answer to the allegations in Paragraph I of plaintiff's First Cause of Action, defendant admits that she is a citizen of the State of California, County of Riverside. Defendant alleges that she has no knowledge or information sufficient to form a belief as to the balance of the allegations in said Paragraph I, and basing her denial on said lack of information or belief, denies each and every other allegation contained in said Paragraph I.

#### II

For answer to the allegations in Paragraph II and III of the First Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraphs contained.

#### III

For answer to the allegations in Paragraph IV of the First Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained, and further defendant specifically denies that by reason of the matters alleged in plaintiff's First Cause of Action, or for any reason or at all, defendant was damaged in the sum of \$500,000.00, or in any other sum whatsoever or at all.



IV

For answer to the allegations in Paragraph V of the First Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained, and further defendant specifically denies that she did the things alleged in the First Cause of Action or any of them, and specifically denies that plaintiff is entitled to exemplary and punitive damages in the sum of \$500,000.00 or in any sum whatsoever or at all.

V

First Affirmative Defense to the First Cause  
of Action

Defendant is informed and believes and upon such information and belief alleges that each and all of the supposed defamatory words set forth in the First Cause of Action in plaintiff's Amended Complaint are true.

As to the Second Cause of Action

I

For answer to the allegations in Paragraph I of plaintiff's Second Cause of Action, defendant readopts and reasserts the allegations and denials hereinabove set forth in Paragraphs I, II, III, and IV of her Answer to the First Cause of Action herein.

II

For answer to the allegations in Paragraph II of plaintiff's Second Cause of Action, defendant admits and alleges that on or about November 26, 1955, there was pending in the Superior Court of the State of California, in and for the County of Riverside, an action for divorce against defendant on a complaint for

divorce filed on or about October 21, 1955, being action No. 62839 on the register of actions in the office of the Clerk of said court entitled: "George Chester Ray Gilliland, also known as G. Ray Gilliland, also known as Ray Gilliland, Plaintiff, vs. Elsinore C. Marchris Gilliland, also known as Elsinore Marchris Gilliland, First Doe to Sixth Doe inclusive, Defendants."

That defendant's attorneys prepared a cross-complaint for divorce in said divorce action No. 62839 on defendant's behalf in which plaintiff herein, Faye Lyons, and one Ann Meyers were named as Co-Respondents in the Second Cause of Action in said cross-complaint for divorce. That the Second Cause of Action in said cross-complaint for divorce in said divorce action No. 62839 contained the following allegation:

"That, in May and June, 1955, the cross-defendant associated with, kept, and did commit adultery with one Faye Lyons, named herein as Co-Respondent, at his residence at 4717 North 71st Place, Scottsdale, Arizona; and that, on the night of September 28, 1955, the cross-defendant did associate with, keep with him overnight, and did commit adultery with said Faye Lyons at the Colonial House, Las Vegas, Nevada, where cross-defendant and said Co-Respondent were registered by him as 'Ray Gilliland and Family.' "

That on or about November 28, 1955, defendant verified said cross-complaint, and on or about November 28, 1955, said cross-complaint was filed in said divorce action No. 62839 by her attorneys.

Further answering the allegations of Paragraph II of the Second Cause of Action defendant admits that

plaintiff herein was not served in said divorce action No. 62839. Defendant alleges that defendant did endeavor to serve plaintiff herein in said divorce action No. 62839. Defendant is informed and believes and upon such information and belief alleges that defendant's attorneys diligently endeavored to ascertain plaintiff's address and place of residence, but were unable, after due diligence, to locate or ascertain the place of residence of plaintiff in order to serve here; defendant alleges that plaintiff has, since shortly after November 29, 1955, had full knowledge of the pendency of said Second Cause of Action of said cross-complaint in divorce action No. 62839, and has not made any appearance therein, although plaintiff has had full and complete opportunity to do so.

Defendant alleges that the parties to said divorce action No. 62839, on or about June 12, 1956, entered into a property settlement agreement, mutually satisfactory to both parties, in which defendant's then husband, George Chester Gilliland, agreed to dismiss with prejudice his complaint for divorce and any affirmative relief sought in his answer to the cross-complaint filed in said action No. 62839; that the plaintiff in said action No. 62839 stipulated in writing that the first cause of action of said cross-complaint based upon extreme cruelty be heard as a default, and on June 13th, 1956, said divorce action was so tried on the issues of the first cause of action of the cross-complaint, and an interlocutory decree of divorce was granted to defendant herein and was entered on June 13, 1956, in Judgment Book 76 Page 630, of the Superior Court of the State of California, in and for the County of Riverside. De-



fendant alleges that said Second Cause of Action in said divorce action No. 62839 has not been dismissed and is still pending.

Defendant denies each and every other allegation in said Paragraph II of plaintiff's Second Cause of Action not hereinabove expressly admitted and alleged.

### III

For answer to the allegations in Paragraph III of plaintiff's Second Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained.

### IV

For answer to the allegations in Paragraph IV of the Second Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained, and further defendant specifically denies that by reason of the matters alleged in plaintiff's Second Cause of Action, or for any reason or at all, defendant was damaged in the sum of \$500,000.00, or in any other sum whatsoever or at all.

### V

For answer to the allegations in Paragraph V of the Second Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained, and further defendant specifically denies that plaintiff is entitled to exemplary and punitive damages in the sum of \$500,000.00 or in any sum whatsoever or at all.

VI

First Affirmative Defense to the Second  
Cause of Action

That the substance of the supposed defamatory words set forth in the Second Cause of Action herein were incorporated as allegations in a cross-complaint for divorce filed in said action No. 62839 on the register of actions in the Superior Court of the State of California, in and for the County of Riverside, in exact words as follows:

“That, in May and June, 1955, the cross-defendant associated with, kept, and did commit adultery with one Faye Lyons, named herein as Co-Respondent, at his residence at 4717 North 71st Place, Scottsdale, Arizona; and that, on the night of September 28, 1955, the cross-defendant did associate with, keep with him overnight, and did commit adultery with said Faye Lyons at the Colonial House, Las Vegas, Nevada, where cross-defendant and said Co-Respondent were registered by him as ‘Ray Gilliland and Family.’ ”

That said allegation is a privileged publication under the provisions of section 47 subd. 2(3) of the Civil Code of the State of California, in the following facts which defendant hereby alleges:

1. That said cross-complaint for divorce was verified by defendant;

2. That the allegations of the supposed defamatory words in said cross-complaint for divorce were made by defendant in good faith and without malice;

3. That at the time the allegations of the supposed defamatory words in said cross-complaint for divorce were made, defendant had good and sufficient reason to believe and did honestly and reasonably believe that said allegations were true, and defendant had reasonable and probable cause for believing the truth of said allegations;

4. That the allegations of the supposed defamatory words in said cross-complaint for divorce were material and relevant to the issues in said action No. 62839;

5. That defendant did not in any other way publish the supposed defamatory words alleged in the Second Cause of Action of the Amended Complaint herein.

## VII

### Third Affirmative Defense to the Second Cause of Action

That the Second Cause of Action fails to state a claim against the defendant upon which relief can be granted.

### As to the Third Cause of Action

#### I

For answer to the allegations of Paragraph II of Plaintiff's Third Cause of Action, defendant admits and alleges that on March 23, 1956, there was published in the Daily Enterprise, a newspaper of general circulation in Riverside, California, a news article describing a hearing on March 22, 1956, in the Superior Court of the State of California, in and for the County of Riverside, the hereinbefore described action No. 62839, and that said article contained, among other statements, substantially the words set forth in quotations in Paragraph II of plaintiff's Third Cause of Action herein.



Except as hereinabove expressly admitted and alleged, defendant denies each and every other allegation in said Paragraph II of plaintiff's Third Cause of Action, and specifically denies that defendant had anything at all to do with said newspaper publication, and specifically denies that said newspaper publication was "by reason of her endeavors," in any manner whatsoever.

### III

For answer to the allegations in Paragraph III of plaintiff's Third Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained.

### IV

For answer to the allegations in Paragraph IV of the Third Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained, and further defendant specifically denies that by reason of the matters alleged in plaintiff's Third Cause of Action, or for any reason or at all, defendant was damaged in the sum of \$500,000.00, or in any other sum whatsoever or at all.

### V

For answer to the allegations in Paragraph V of the Third Cause of Action, defendant denies each and every allegation, statement, and averment in said paragraph contained, and further defendant specifically denies that she did the things alleged in the Third Cause of Action or any of them, and specifically denies that plaintiff is entitled to exemplary and punitive damages in the sum of \$500,000.00, or in any sum whatsoever or at all.

## VI

First Affirmative Defense to Third  
Cause of Action

Defendant is informed and believes and upon such information and belief alleges that the supposed defamatory words set forth in plaintiff's Third Cause of Action are true.

## VII

Second Affirmative Defense to Third Cause  
of Action

That the substance of the supposed defamatory words set forth in the Third Cause of Action were incorporated as allegations in the Second Cause of Action of a cross-complaint for divorce filed in said action No. 62839, on the register of actions in the Superior Court of the State of California, in and for the County of Riverside, in exact words as follows:

"That, in May and June 1955, the cross-defendant associated with, kept, and did commit adultery with one Faye Lyons, named herein as Co-Respondent, at his residence at 4717 North 71st Place, Scottsdale, Arizona; and that, on the night of September 28, 1955, the cross-defendant did associate with, keep with him overnight, and did commit adultery with said Faye Lyons at the Colonial House, Las Vegas, Nevada, where cross-defendant and said Co-Respondent were registered by him as 'Ray Gilliland and Family.' "

That said allegation is a privileged publication under the provisions of section 47 subd. 2(3) of the Civil Code of the State of California, in the following facts which defendant hereby alleges:

1. That said cross-complaint for divorce was verified by defendant;

2. That the allegations of the supposed defamatory words in said cross-complaint for divorce were made by defendant in good faith and without malice;

3. That at the time the allegations of the supposed defamatory words in said cross-complaint for divorce were made the defendant had good and sufficient reason to believe and did honestly and reasonably believe that said allegations were true, and defendant had reasonable and probable cause for believing the truth of said allegations;

4. That the allegations of the supposed defamatory words in said cross-complaint for divorce were material and relevant to the issues in said action No. 62839;

5. That defendant did not in any other way publish the said supposed defamatory words.

### VIII

#### Third Affirmative Defense to Third Cause of Action

That the Third Cause of Action fails to state a claim against the defendant upon which relief can be granted.

Wherefore, defendant prays that plaintiff take nothing by her action, and that defendant have judgment against plaintiff for her costs of suit, and for such other and further relief as to the court may seem just.

WM. L. MURPHEY and  
JOHN B. ANSON,

/s/ By WM. L. MURPHEY,  
Attorneys for Defendant.

Duly Verified.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed Dec. 28, 1956.



[Title of District Court and Cause.]

AMENDMENT TO ANSWER TO  
AMENDED COMPLAINT

As an amendment to her answer to the second cause of action of plaintiff's amended complaint, defendant alleges as follows:

VIII

Fourth Affirmative Defense to the Second  
Cause of Action

The allegation contained in paragraph II of the second cause of action of plaintiff's amended complaint, to wit, "That, in May and June, 1955, Ray Gilliland associated with, kept, and did commit adultery with one Faye Lyons, at his residence at 4717 North 71st Place, Scottsdale, Arizona; . . ." is true.

WM. L. MURPHEY and  
JOHN B. ANSON,  
LARWILL AND WOLFE,

/s/ By WM. L. MURPHEY,  
Attorneys for Defendant.

Receipt of Copy.

[Endorsed]: Lodged May 20, 1960. Filed June 20, 1960.

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United States District Court  
Southern District of California  
Central Division

No. 20301-WM Civil

FAYE LYONS,

Plaintiff,

vs.

ELSINORE C. MACHRIS GILLILAND, also known  
as ELSINORE MACHRIS GILLILAND,

Defendant.

VERDICT

We, the jury in the above entitled cause, find that the defense of truth of the alleged libel has not been established, but that the defense of privilege has been established, and therefore find in favor of the defendant, Elsinore C. Machris Gilliland.

Los Angeles, California.

February 7, 1961.

/s/ C. L. CHURCHILL,  
Foreman of the Jury.

[Endorsed]: Filed Feb. 7, 1961.

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United States District Court  
Southern District of California  
Central Division

No. 20301 PH

FAYE LYONS,

Plaintiff,

vs.

ELSINORE C. MACHRIS GILLILAND, also known  
as ELSINORE MACHRIS GILLILAND,

Defendant.

JUDGMENT ON VERDICT

This action came on for trial on 31 January 1961, in the above-entitled Court before said Court and a jury, and said action having been tried and the jury, on 7 February 1961 having duly rendered its verdict finding that the defense of truth of the alleged libel has not been established, but that the defense of privilege has been established, and therefore finding in favor of the defendant, Elsinore C. Machris Gilliland,

It Is Therefore Ordered, Adjudged and Decreed:

That the plaintiff Faye Lyons, take nothing herein and that the defendant Elsinore C. Machris Gilliland, also known as Elsinore Machris Gilliland, have judgment against plaintiff, Faye Lyons, for her costs herein, taxed by the Clerk on June 16, 1958 in the sum of \$200.12, and on February .... 1961 in the sum of \$.....



Witness, The Honorable Wm. C. Mathes, United States District Judge, Southern District of California, this 10th day of February 1961. Costs taxed \$203.03.

JOHN A. CHILDRESS,  
Clerk.

/s/ By B. T. ERICKSEN,  
Deputy Clerk.

Approved as to form:

/s/ WELBURN MAYOCK,  
Attorney for Plaintiff.

Receipt of Copy.

[Endorsed]: Filed and Entered Feb. 10, 1961.

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[Title of District Court and Cause.]

### NOTICE OF APPEAL

Notice is hereby given that Fay Lyons, the plaintiff above-named, hereby appeals to the United States Court of Appeals for the Ninth Circuit from the judgment on the verdict entered in this action on February 10, 1961.

Dated: March 24, 1961.

WELBURN MAYOCK,  
W. S. MAYOCK,  
/s/ By WELBURN MAYOCK,  
Attorneys for Plaintiff & Appellant.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed March 24, 1961.

[Title of District Court and Cause.]

APPELLANT'S DESIGNATION OF  
RECORD TO BE PRINTED

Appellant hereby designates the following portions of the record to be contained in the record on appeal:

1. Amended Complaint, filed 11/20/56
2. Answer to Amended Complaint, filed 12/28/56
3. Amendment to Answer to Amended Complaint, filed 6/20/60
4. Verdict
5. Judgment
6. Order on Plaintiff's Motion for New Trial
7. Notice of Appeal
8. Plaintiff's exhibits 1 to 13, inclusive
9. Defendant's exhibits A to F, inclusive
10. The following portions of the reporter's official transcript of proceedings: February 2, 3, and 6, 1961, to wit: testimony of all witnesses for plaintiff and testimony of all witnesses for defendant
11. This Designation of Contents of Record on Appeal.

Dated: April 6, 1961.

Respectfully submitted,

WELBORN MAYOCK,  
W. S. MAYOCK,

Attorneys for Plaintiff & Appellant,  
/s/ By WELBURN MAYOCK.

Affidavit of Service by Mail Attached.

[Endorsed]: Filed April 6, 1961.

[Title of District Court and Cause.]

CERTIFICATE BY THE CLERK

I, John A. Childress, Clerk of the above-entitled Court, hereby certify that the foregoing documents together with the other items, all of which are listed below, constitute the transcript of record on appeal to the United States Court of Appeals for the Ninth Circuit, in the above-entitled case:

Page:

- 1 Names and Addresses of Attorneys
- 2 Amended Complaint, filed 11/20/56
- 10 Answer to Amended Complaint, filed 12/28/56
- 20 Amendment to Answer to Amended Complaint, filed 6/20/60
- 22 Verdict, filed 2/7/61
- 23 Judgment on the Verdict, filed and entered 2/10/61
- 25 Order on Motion of Plaintiff for a New Trial, filed 2/27/61
- 26 Notice of Appeal, filed 3/24/61
- 28 Appellant's Designation of record to be printed, filed 4/6/61
- 31 Affidavit of W. S. Mayock in support of request for order extending time to file record and docket appeal, filed 5/3/61
- 33 Order extending time to file record and docket appeal, filed 5/3/61



Two volumes of Reporter's transcript of proceedings had on:

January 31 and February 2, 1961—Volume 1

February 3 and 6, 1961—Volume 2

Plaintiff's Exhibits 1, 2-A to 2-E, 3 to 13 inclusive.

Defendant's Exhibits A to F inclusive.

Dated: May 5, 1961.

[Seal]

JOHN A. CHILDRESS,  
Clerk,

/s/ By WM. A. WHITE,  
Deputy Clerk.

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[Endorsed]: No. 17362. United States Court of Appeals for the Ninth Circuit. Fay Lyons, Appellant, vs. Elsinore C. Machris Gilliland, also known as Elsinore Machris Gilliland, Appellee. Transcript of Record. Appeal from the United States District Court for the Southern District of California, Central Division.

Filed May 6, 1961.

Docketed May 16, 1961.

/s/ FRANK H. SCHMID,  
Clerk of the United States Court of Appeals for the  
Ninth Circuit.

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United States Court of Appeals  
for the Ninth Circuit

No. 17362

(U.S. Dist. Ct. No. 20301-WM)

FAY LYONS,

Appellant,

vs.

ELSINORE C. MACHRIS GILLILAND, also known  
as ELSINORE MACHRIS GILLILAND,

Respondent.

NOTICE OF MOTION

To Elsinore C. Machris Gilliland, aka Elsinore Machris, Gilliland, and to Charles W. Wolfe and George R. Larwill, her Attorneys:

You and each of you will please take notice that on Monday, July 24, 1961 at 10 a.m. of that day in the court room of said Honorable Court, U. S. Postoffice and Courthouse, San Francisco 1, California, Appellant will move said Honorable Court for an Order permitting Appellant to proceed on the following record:

1. A printed judgment-roll containing the Amended Complaint, Answer to Amended Complaint, Amendment to Answer to Amended Complaint, Verdict, Judgment, Certificate of Clerk to Transcript of Record, Notice of Appeal, and Designation of Record to be Printed;

2. The typewritten Reporter's Transcript;
3. The original Exhibits.

Dated: July 10, 1961.

WELBURN MAYOCK,  
W. S. MAYOCK,

/s/ By WELBURN MAYOCK,  
Attorneys for Appellant.

Ordered: Acquitted 7-19-61.

Barnes,  
C. J.

[Endorsed]: Filed July 12, 1961. Frank H. Schmid,  
Clerk.

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[Title of Court of Appeals and Cause.]

#### DESIGNATION OF POINTS ON APPEAL

Appellant hereby designates the following points to be urged on appeal:

I. The verdict that the defamatory publication of the libel was privileged as to defendant is not supported by the evidence and is against law.

It was found that the charge of adultery was not true.

Only evidence known to the defendant at the time of the publication is available to establish privilege. Defendant's attempt to justify a reasonable inference upon



which to base the defense of "privilege" fails of the essential element of "propensity" on the part of the parties. "Propensity" on the part of Mr. Gilliland was known to the defendant.

There is no evidence of "propensity" on the part of the plaintiff.

Propensity of both is essential to prove adultery by indirect evidence.

II. The jury has found that the charge of adultery was not true. There is no legal basis in the evidence to support a verdict of "privilege".

The only undecided issue for a new trial is the issue of damages. It is urged that the judgment be reversed and that a new trial be ordered on the single issue of damages.

Dated: November 15, 1961.

Respectfully submitted,

WELBURN MAYOCK and  
W. S. MAYOCK,

/s/ By W. S. MAYOCK,  
Attorneys for Appellant.

[Endorsed]: Filed November 17, 1961. Frank H. Schmid, Clerk.



